PRINCIPLES OF ECONOMICS

ACCOUNTING TECHNICIAN DIPLOMA (ATD)

ATD LEVEL III

STUDY TEXT
GENERAL OBJECTIVES

This paper is intended to equip the candidate with knowledge, skills and attitudes that will enable him/her to apply the fundamental principles of economics in decision making.

4.0 LEARNING OUTCOMES

A candidate who passes this paper should be able to:

- Apply basic mathematical and graphical techniques to analyse economic relationships and interpret the results.
- Apply the knowledge of economics in decision making.
- Analyse economic problems and suggest possible policy related recommendations.
- Apply knowledge of economics in international trade and finance.
- Apply economic principles in the development and implementation of policies in agriculture and industry.
- Demonstrate an understanding of emerging economic issues.

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Revised on: June 2016
MICROECONOMICS

TOPIC 1

INTRODUCTION TO ECONOMICS

DEFINITION OF ECONOMICS

The modern word "Economics" has its origin in the Greek word "Oikonomos" meaning a steward. The two parts of this word "Oikos", a house and "nomos", a manager sum up what economics is all about. How do we manage our house, what account of stewardship can we render to our families, to the nation, to all our descendants?

There is an economic aspect to almost any topic we care to mention – education, employment, housing, transport, defence etc. Economics is a comprehensive theory of how the society works. But as such, it is difficult to define. The great classical economist Alfred Marshal defined economics as the "Study of man in the ordinary business of life".

This, however, is rather too vague a definition. This is because any definition should take account of the guiding idea in economics which is scarcity. The great American economist Paul Samuelson thus defined it as: "The study of how people and society choose to employ scarce resources that could have alternative uses in order to produce various commodities and to distribute them for consumption, now or in future amongst various persons and groups in society. Virtually everything is scarce; not just diamonds and oil but also bread and water. The word scarcity as used in economics means that; All resources are scarce in the sense that there are not enough to fill everyone's wants to the point of satiety.

We therefore have limited resources, both in rich countries and in poor countries. The economist’s job is to evaluate the choices that exist for the use of these resources. Thus we have another characteristic of economics; it is concerned with choice.

Another aspect of the problem is people themselves; they do not just want more food or more clothing they want particular types of food, specific items of clothing and so on. By want we mean; "A materialistic desire for an activity or an item. Human wants are infinite.

We have now assembled the three vital ingredients in our definition, People (human wants), Scarcity and choice. Thus for our purpose we could define economics as:

"The social science which is concerned with the allocation of scarce resources to provide goods and services which meet the needs and wants of the consumers"
(ii) The Scope of Economics

The study of economics begins with understanding of human “wants”. Scarcity forces us to economise. We weigh up the various alternatives and select that particular assortment of goods which yields the highest return from our limited resources. Modern economists use this idea to define the scope of their studies.

Although economics is closely connected with such social sciences as ethics, politics, sociology, psychology and anthropology, it is distinguished from them by its concentration on one particular aspect of human behaviour – choosing between alternatives in order to obtain the maximum satisfaction from limited resources.

In effect, the economist limits the study by selecting four fundamental characteristics of human existence and investigating what happens when they are all found together, as they usually are.

First, the ends of human beings are without limit. Second, those ends are of varying importance. Third, the means available for achieving those ends – human time and energy and material resources – are limited. Fourth, the means can be used in many different ways: that is, they can produce many different goods.

But no single characteristic by itself is necessarily of interest to the economist. Only when all four characteristics are found together does an economic problem arise.

Resources: The ingredients that are combined together by economists and termed economic goods i.e. goods that are scarce in relation to the demand for them.

i. Economic Goods: All things which people want are lumped together by economists and termed economic goods i.e. goods that are scarce in relation to the demand for them.

ii. Free Goods: These are goods which people can have as much as they want, e.g. air.

MICROECONOMICS AND MACROECONOMICS

Overall the study of economics is divided into two halves, microeconomics and macroeconomics.

(a) "Micro" comes from the Greek word meaning small, and microeconomics is the study of individual economic units or particular parts of the economy e.g. how does an individual household decide to spend its income? How does an individual firm decide what volume of output to produce or what products to make? How is price of an individual product determined? How are wage levels determined in a particular industry? It thus gives a worm’s eye view of the economy.

(b) "Macro" comes from the Greek word meaning large, and macroeconomics is the study of "global" or collective decisions by individual households or producers. It looks at a national or international economy as a whole, e.g. Total Output, Income and Expenditure,
Unemployment, Inflation Interest Rates and Balance of International Trade, etc and what economic policies a government can pursue to influence the conditions of the national economy. It thus gives a bird's eye-view of the economy.

Economic theory

A body of economic principles built up as a result of logical reasoning, it provides the tools of economic analysis. It is pursued irrespective of whether it appears to be of any practical advantage or not.

THE METHODOLOGY OF ECONOMICS AND ITS BASIC CONCEPTS

Economics proceeds as an evolutionary discipline, looking at data, developing hypotheses, testing them and reaching sometimes uneasy consensus on how the economy works. This is called the scientific method which begins with the formulation of a theory about behaviour. For example, we may put forward the idea that the demand for a good is determined by its price. On the basis of this we may reason that as the price is increased, demand goes down, while if the prices are decreased the demand will go up. This then gives us a hypothesis which can be tested on observed behaviour. This testing of ideas on the evidence is known as empiricism.

Ceteris paribus

The economic world is extremely complicated. There are millions of people and firms; thousands of prices and industries. One possible way of figuring out economic laws in such a setting is by controlled experiments. A controlled experiment takes place when everything else but the item under investigation is held constant. This is an essential component of scientific method.

However economists have no such luxury when testing economic laws. Therefore, when formulating economic principles economists are usually careful to state that such and such will happen, ceteris paribus which is the Latin expression meaning all other things remaining constant.

ECONOMIC DESCRIPTION AND ANALYSIS

Economics is used in two important ways today. The first is to describe, explain and predict the behaviour of production, inflation, incomes etc. But for many, the fruit of such labours is found in a second task – to improve economic performance.

Thus, we first attempt to describe the hardships of poverty. We then might present programs that could reduce the extent of poverty. Or we might start with an analysis of how higher energy taxes would lead to lower energy consumption. We might then conclude that the country should raise its gasoline taxes.
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TOPIC 2
DEMAND, SUPPLY AND DETERMINATION OF EQUILIBRIUM

DEMAND ANALYSIS

Introduction
In any economy there are millions of individuals and institutions and to reduce things to a manageable proportion they are consolidated into three important groups; namely

- Households
- Firms
- Central Authorities

These are the *dramatis personae* of the economic theory and the stage on which much of their play is acted is called the MARKET (see lesson three for definition of market).

**Household**
This refers to all the people who live under one roof and who make or are subject to others making for them, joint financial decisions. The household decisions are assumed to be consistent, aimed at *maximizing utility* and they are the principal owners of the factors of production. In return for the factors or services of production supplied, they get or receive their income e.g.

- Labour – wages and salaries
- Capital – interest
- Land – rent
- Enterprise – profit

**The firm**
The unit that uses factors of production to produce commodities then it sells either to other firms, to household, or to central authorities. The firm is thus the unit that makes the decisions regarding the employment of the factors of production and the output of commodities. They are assumed to be aiming at *maximizing profits*.

**Central authorities**
This comprehensive term includes all public agencies, government bodies and other organisations belonging to or under the direct control of the government. They exist at the centre of legal and political power and exert some control over individual decisions taken and over markets.
DEMAND ANALYSIS

DEFINITION

Demand is the quantity per unit of time, which consumers (households) are willing and able to buy in the market at alternative prices, other things held constant.

INDIVIDUAL VERSUS MARKET DEMAND

(i) Individual and market demand schedule

The plan of the possible quantities that will be demanded at different prices by an individual is called Individual demand schedule. Such a demand schedule is purely hypothetical, but it serves to illustrate the First Law of Demand and Supply that more of a commodity will be bought at a lower than a higher price.

<table>
<thead>
<tr>
<th>PRICE (SH)</th>
<th>QUANTITY DEMANDED PER WEEK</th>
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<tbody>
<tr>
<td>20</td>
<td>3</td>
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<tr>
<td>18</td>
<td>3.5</td>
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<td>16</td>
<td>4</td>
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<td>9</td>
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Table : The individual demand schedule

Theoretically, the demand schedule of all consumers of a given commodity can be combined to form a composite demand schedule, representing the total demand for that commodity at various prices. This is called the Market demand schedule.

<table>
<thead>
<tr>
<th>PRICE(SH)</th>
<th>QUANTITY DEMANDED PER WEEK</th>
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<tr>
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<td>100000</td>
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<td>18</td>
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<td>16</td>
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<td>11</td>
<td>200000</td>
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<td>9</td>
<td>300000</td>
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<tr>
<td>8</td>
<td>350000</td>
</tr>
</tbody>
</table>
Table: The market demand schedule.

These prices are called Demand Prices. Thus, the demand price for 200,000 units per week is KShs 11 per unit.

(ii) The individual and market demand curves

The quantities and prices in the demand schedule can be plotted on a graph. Such a graph after the individual demand schedule is called The Individual Demand Curve and is downward sloping.

An individual demand curve is the graph relating prices to quantities demanded at those prices by an individual consumer of a given commodity.

The curve can also be drawn for the entire market demand and is called a Market Demand Curve:

A market demand curve is the horizontal summation of the individual demand curves i.e. by taking the sum of the quantities consumed by individual consumers at each price.

Consider a market consisting of two consumers:
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TOPIC 3
THEORY OF THE CONSUMER BEHAVIOUR

APPROACHES TO THE THEORY OF THE CONSUMER

CARDINAL VERSUS ORDINAL APPROACH

Through the study of theory of consumer behaviour we can be able to explain why consumers buy more at a lower price than at a higher price or put differently why individuals or households spend their money as they do. We shall assume that the consumer is rational and aims at maximising his satisfaction, so given his income he consumes that basket of goods and services which produces maximum satisfaction. Two major theories explain the behaviour of the consumer, neither presents a totally complete picture. The first approach is the marginal utility, or cardinalist approach. The second approach centres on the indifference curve analysis or the ordinalist approach.

CARDINAL UTILITY APPROACH

The downward sloping nature of the demand curve can be explained by using the law of diminishing marginal utility. For instance, consider a consumer who has to choose between two goods, X and Y, which have prices Px and Py respectively. Assume that the individual is rational and so wishes to maximise total utility subject to the size of the income.

The consumer will be maximising total utility when his or her income has been allocated in such a way that utility to be derived from the consumption of one extra shilling worth of X is equal to the utility to be derived from the consumption of one extra shilling worth of Y. In other words, when the marginal utility per shilling of X is equal to the marginal utility per shilling of Y. Only when this is true will it not be possible to increase total utility by switching expenditure from one good to another. This condition for consumer equilibrium can be written as follows:

\[ \frac{MU_X}{P_X} = \frac{MU_Y}{P_Y} \]

Where \( MU_X \) and \( MU_Y \) are the marginal utilities of X and Y respectively and \( P_X \) and \( P_Y \) are the prices (in shillings) of X and Y respectively.

Any number of commodities may then be added to the equation. The table below gives hypothetical marginal utility figures for a consumer who wishes to distribute expenditure of K£44 between three commodities X, Y and Z.
Marginal utilities derived from each Kg of:

<table>
<thead>
<tr>
<th>Kg consumed</th>
<th>x (£8/kg)</th>
<th>Y (£4/kg)</th>
<th>Z (£2/kg)</th>
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<tbody>
<tr>
<td>1</td>
<td>72</td>
<td>60</td>
<td>64</td>
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In order to maximize utility, the consumer must distribute available income so that:

\[
\frac{M_{ux}}{P_X} = \frac{M_{uy}}{P_Y} = \frac{M_{uz}}{P_z}
\]

From the table you can see that this yields, a selection where the consumer buys 2 kg of X, 4 kg of Y and 6 kg of Z. Hence:

\[
\frac{48}{8} = \frac{24}{4} = \frac{12}{2}
\]

If the consumer wishes to spend all the £44, it is impossible to distribute it any other way which would yield greater total quality. This theorem is called the concept of **equi-marginal utilities**.

**The demand curve**

Suppose that starting from a condition of equilibrium, the price of X falls relative to Y. We now have a condition where the utility from the last shilling spent on X will be greater than the utility from the last shillings spent on Y. Mathematically this can be written as:

\[
\frac{M_{ux}}{P_X} > \frac{M_{uy}}{P_Y}
\]

In order to restore the equilibrium the consumer will buy more of X (and less of Y), thus reducing the marginal utility of X. The consumer will continue substituting X for Y until equilibrium is achieved. Thus we have attained the normal demand relationship that, ceteris paribus, as the price of X falls, more of it is bought. We have therefore a normal downward sloping demand curve. The demand curve we have derived is the individuals’ demand curve for a product. The market demand curve can be then obtained by aggregating all the individual demand curves.

The explanation we have obtained here is of the price (or substitution) effect.
Market demand and consumers surplus.

Suppose that the market price of a cup of coffee is £4 but the consumer was willing to pay £9 for the first unit, £8 for the second, £7 for the third, £6 for the fourth, £5 for the fifth and £4 for the sixth.

However, he pays the market price for all the six cups. The consumer thus earns a surplus on the first five units consumed i.e.

A measure of the difference between the value that consumers place on their total consumption of some commodity and the amount they actually pay for it.

For continuous demand curves, consumer’s surplus can be measured by the area under the demand curve and above the price.

NB: The shaded area represents utility which the consumers received but did not pay for i.e. consumer surplus.

Mathematically it can be calculated as follows:

£5 + £4 + £3 + £2 + £1 = £15

ORDINAL APPROACH

In the 1930s a group of economists, including Sir John Hicks and sir Roy Allen, came to believe that cardinal measurement of utility was not necessary. They argued that demand behavior could be explained with ordinal numbers (that is, first, second, third, and so on). This is because, it is argued, individuals are able to rank their preferences, saying that they would prefer this bundle of goods to that bundle of goods and so on. Finite measurement of utility therefore becomes unnecessary and it’s sufficient simply to place in order consumers preference to investigate this we must investigate indifference curves.

UTILITY ANALYSIS, MARGINAL UTILITY(MU), LAW OF DIMINISHING MARGINAL UTILITY

Utility

Utility is the amount of satisfaction derived from the consumption of a commodity or service at a particular time. Utility is not inherent but a psychological satisfaction, i.e. depends on the individual’s own subjective estimate of the amount of satisfaction to be obtained from the consumption of the commodity.

Marginal Utility

The extra utility derived from the consumption of one more unit of a good, the consumption of all other goods remaining unchanged.
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TOPIC 4

THE THEORY OF PRODUCTION

FACTORS OF PRODUCTION

The sum total of the economic resources which we have in order to provide for our economic
wants are termed as factors of production. Traditionally economists have classified these under
four headings. They are:

i. Labour
ii. Land
iii. Capital
iv. Enterprise

The first two are termed primary factors since they are not the result of the economic process;
they are, so to speak, what we have to start with. The secondary factors, however are a
consequences of an economic system.

i) Land

The term land is used in the widest sense to include all the free gifts of nature; farmlands,
minerals wealth such as coal mines, fishing grounds, forests, rivers and lakes.

In practise it may be very difficult to separate land from other factors of production such
ascapital but, theoretically, it has two unique features which distinguish it.

Firstly, it is fixed in supply. As land includes the sea in definition, then we are thus talking about
the whole planet, and it is obvious that we cannot acquire more land in this sense.

Secondly, land has no cost of production. The individual who is trying to rent a piece of land
may have to pay a great deal of money but it never cost society as a whole anything to
produce land.

ii) Capital

Capital as a factor of production can be defined either as the stock of wealth existing at any one
time and as such, capital consists of all the real physical assets of society. An alternative
formulation of capital is that it refers to all those goods, which are used in the production of
further wealth.

Capital can be divided into fixed capital, which is such things as building, roads, machinery etc
and working capital or circulating capital which consists of stocks of raw materials and semi-
manufactured goods. The distinction is that fixed capital continues through many rounds of
production while working capital is used up in one round; For example, a classroom would be
fixed capital, while stocks of chalk to be used for writing would be circulating/working capital.
As stated previously, capital is a secondary factor of production, which means that results from the economics system. Capital has been created by individuals forgoing current consumption, i.e. people have refrained from consuming all their wealth immediately and have saved resources which can then be used in the production of further wealth.

iii) Labour

Labour is the exercise of human, physical and mental effort directed to the production of goods and services. Included in this definition is all the labour which people undertake for reward, either in form of wages and salaries or incomes from self employment. We would not, therefore include housework or the efforts of do-it-yourself enthusiasts, even though these may be hard work.

Some aspects of labour

Labour is no doubt the most important of all factor or production, for the efficiency of any production will to a large extent depend on the efficiency and supply of the labour working in the process. Besides labour is also the end for which all production is undertaken.

Supply of labour

Supply of labour refers to the number of workers (or, more generally, the number of labour hours) available to an economy. The supply of labour will be determined by:

I. Population Size

In any given economy, the population size determines the upper limit of labour supply. Clearly there cannot be more labour than there is population.

II. Age Structure

- The population is divided into three age groups. These are:
- The young age group usually below the age of 18, which is considered to be the minimum age of adulthood. People below this age are not in the labour supply, i.e. they are not supposed to be working or looking for work.
- The working age group, usually between 18 and 60, although the upper age limit for this group varies from country to country. In Kenya for example, for public servants, it is 55 years. It is the size of this group which determines the labour supply.
- The old age group, i.e. above 60 years are not in the labour force.

III. The Working Population

Not everybody in the working age group will be in the labour force. What is called the working population refers to the people who are in the working group, and are either working or are actively looking for work, i.e. would take up work if work was offered to them. These are sometimes called the actively active people. Hence this group excludes the sick, the aged, the disabled and (full time) housewives, as well as students. These are people who are working and are not willing or are not in a position to take up work was given to them.
IV. Education System

If the children are kept in school longer, then this will affect the size of the labour force of the country.

V. Length of the Working Week

This determines labour supply in terms of Man-hours. Hence the fewer the holidays there are, the higher will be the labour supply. This does not, however mean that if the number of working hours in the week are reduced, productivity if there is a high degree of automation.

VI Remuneration

The preceding five factors affect the supply of labour in totality. Remuneration affects the supply of labour to a particular industry. Thus, an industry which offers higher wages than other industries will attract labour from those other industries.

VII The Extent to Barriers to Entry into a Particular Occupation

If there are strong barriers to the occupation mobility of labour into a particular occupation, e.g. special talents required or long periods of training, the supply of labour to that occupation will be limited.

Efficiency of Labour

Efficiency of labour refers to the ability to achieve a greater output in a shorter time without any falling off in the quality of the work – that is to say, increase productivity per man employed. The efficiency of a country’s labour force depends on a number of influences.

i. Climate

This can be an important influence on willingness to work, for extremes of temperatures or high, humidity are not conducive to concentration even on congenial tasks.

ii. Education and training

Education and training produce skills and therefore efficient labour. Education has three aspects: general education, technical education and training within industry. A high standard of general education is essential for developing intelligence and providing a foundation upon which more specialized vocational training can be based. Technical training provided in the universities, colleges and by industry itself. Training within industry is given by each firm to its employees.

iii. Working Conditions

Research has shown that if working conditions are safe and hygienic, the efficiency of labour will be higher than if the conditions were unsafe or unhygienic.

iv. Health of the worker
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TOPIC 5
MARKET STRUCTURES

DEFINITION OF A MARKET

A Market may be defined as an area over which buyers and sellers meet to negotiate the exchange of a well-defined commodity. Markets may also mean the extent of the sale for a commodity as in the phrase, “there is a wide market for this or that commodity”. In a monetary economy, market means the business of buying and selling of goods and services of some kind.

Concepts to know:

i. **Average Revenue (AR):** This is the revenue per unit of the commodity sold. It is obtained by dividing Total Revenue by total quantity sold. For a firm in a perfectly competitive market, the AR is the same as price. Therefore, if price is denoted by P, then we can say:

\[ P = AR \]

Because of this, the demand curve which relates prices to quantities demanded at those prices is also called Average Revenue Curve. In economic theory, the demand curve or price line is often referred to as the revenue curve.

ii. **Marginal Revenue (MR):** This is the increase in Total Revenue resulting from the sale of an extra unit of output. Thus, if \( TR_{n-1} \) is Total Revenue from the sale of \((n-1)\) units and \( TR_n \) is total revenue from the sale of \(n\) units, then the marginal revenue of the \(n\)th unit is given as:

\[ dTR = P(1 - 1/Ed) \text{ or } TR_n - TR_{n-1} \]

\[ dQ \]

iii. **Total Revenue:** The money value of the total amount sold and is obtained by multiplying the price by the total quantity sold.

NECESSARY AND SUFFICIENT CONDITIONS FOR PROFIT MAXIMIZATION

Two conditions that however prevail, namely:

i. The necessary condition is that

\[ w/r = MPL/MPk \text{ or } MPL/PL = MPk/Pk \]

ii. The sufficient condition is that the Isoquant must be convex to the Isocost point of Tangency.
MATHEMATICAL APPROACH TO PROFIT MAIMIZATION

An industry which is categorized as perfectly competitive is composed of many sellers (such as porn) providing a homogeneous (having all terms/products of the same degree/kind) good to numerous buyers who are all informed about the product. Both buyers and sellers are free to enter and exit a competitive market at any time. In such a free market, individual firms have no control over price; instead these firms are forced to sell their goods at a price which is determined by the market as a whole. If they choose to sell goods at a higher price, they will not be able to sell much (if any) because consumers could buy homogeneous products from another firm at a lower price. If they choose to sell the good at a lower price, they would sell an infinite (if possible) number of goods, forcing all other firms to lower their price as well. This concept is what gives rise to competitive firms being referred to as “price takers.”

Competitive firms’ prices are determined by the market, and all goods are sold to all consumers at that same price. Additional revenue added by each unit sold (marginal revenue) will be equal to the price at which that last unit was sold, and because this price will be the same for that unit as any other unit in a competitive industry, price will always be equal to marginal revenue (P=MR).

Since competitive firms have no control over the price at which their goods are sold, their only hope to maximize profits is to choose the optimal quantity of goods to sell (Q). There are two methods by which one can solve for the optimal quantity for a perfectly competitive firm to produce and sell:

1. Total Revenue (TR) and Total Cost (TC)
2. Marginal Revenue (MR) and Marginal Cost (MC)

Each of these methods will be demonstrated with an example

*NOTE: To maximize any equation we must find where the slope of the equation’s graph is equal to zero. Because the slope of one equation’s line is equal to the derivative of that equation at a given point, we can maximize a given equation by setting the derivative of that equation equal to zero.

1. Total Revenue and Total Cost (everything expressed in dollars)

Given: TC= 100 + 10Q + Q²

P= 50

We must first figure TR

TR= P x Q  but since we know  P= 50

TR= 50 x Q

Profit (pi) function: pi= TR – TC
Plug in values for both TR and TC

\[ \text{TR} = 50 \times Q \]
\[ \text{TC} = 100 + 10Q + Q^2 \]
\[ \pi = \text{TR} - \text{TC} \]
\[ \pi = 50Q - (100 + 10Q + Q^2) \]
\[ \pi = 50Q - 100 - 10Q - Q^2 \]
\[ \pi = 40Q - 100 - Q^2 \]

Next, find the derivative of the profit function with respect to Q.
\[ \frac{d(\pi)}{dQ} \text{ with respect to } Q = 40 - 2Q \]
To maximize profit, set the derivative of the profit function equal to zero and solve for Q

\[ 40 - 2Q = 0 \]
\[ 40 = 2Q \]
\[ 20 = Q \]
To maximize profits this competitive producer will produce 20 units to sell them at a price of $50

2. Marginal Revenue and Marginal Cost (everything expressed in dollars)
We already know:

\[ \frac{d\text{TR}}{dQ} = \text{MR} \quad \text{slope of TR curve} \]
\[ \frac{d\text{TC}}{dQ} = \text{MC} \quad \text{slope of TC curve} \]
\[ \pi = \text{TR} - \text{TC} \]

Find the derivative of the profit function with respect to Q

\[ \frac{d\pi}{dQ} = \frac{d\text{TR}}{dQ} - \frac{d\text{TC}}{dQ} \]
To maximize profit, set the derivative of the profit function equal to zero

\[ \frac{d\text{TR}}{dQ} - \frac{d\text{TC}}{dQ} = 0 \]
Since we know that those above fractions are equal to MR and MC respectively we can substitute them into the equation

\[ \text{MR} - \text{MC} = 0 \]
MR = MC

For a competitive firm to maximize profits they must produce at an output where MR is equal to MC
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DEFINITION OF NATIONAL INCOME

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

THE CIRCULAR FLOW OF INCOME AND EXPENDITURE

This is an economic model illustrating the flow of payments and receipts between domestic firms and domestic households. The households supply factor services to the firms. In return, they get factor incomes. With factor incomes, they buy goods and services from the firms. These flows can be illustrated diagrammatically as follows:

![Diagram of Circular Flow of Income and Expenditure]

The points at which flows from one sector meets the other sector and generate other flows are called critical points. In the above diagram, the critical points are A, B and C. At A, the flow of
factor services from the households sector meets the firm sector and generates the flow of **factors incomes** from the firms to the households. At B, the flow of factor incomes meets the household sector and generates the flow of **consumer spending**. At C, the flow of consumer spending meets the firms sector and generates the flow of **goods and services**.

**APPROACHES TO MEASURING NATIONAL INCOME**

The compilation of national income statistics is a very laborious task. The total wealth of a nation has to be added up and there are millions of nationals. Moreover, in order to double check and triple check the statistics, the national income statistician has to work out the figures out in three different ways, each way being based on a different aspect. The three aspects are:

a. **The national output**: - The creation of wealth by the nation’s industries. This is valued at factor cost, so it must be the same as b) below.

b. **The national income**: - The incomes of all the citizens.

c. **The national expenditure** because whatever we receive we spend, or lend to the banks to invest it, so that the addition of all the expenditure should come to the same as the other two figures.

Put in its simplest form we can express this as an identity:

\[
\text{National output} \equiv \text{National Income} \equiv \text{National Expenditure}.
\]

(i) Using Total Expenditure for Calculating National Income

The expenditure approach centres on the components of **final demand** which generate production. It thus measures GDP as the total sum of expenditure on **final goods and services** produced in an economy. It includes all consumers’ expenditure on goods and services, except for the purchase of new houses which is included in gross **fixed capital formulation**. Secondly we included all general **government final consumption**. This includes all current expenditure by **central and local** government on goods and services, including wages and salaries of government employees. To these we add **gross fixed capital formation or expenditure on fixed assets** (buildings, machinery, vehicles etc) either for replacing or adding to the stock of existing fixed assets. This is the major part of the investment which takes place in the economy. In addition we add the **value of physical increases in the stocks, or inventories**, during the course of the year. The total of all this gives us **Total domestic expenditure** (TDE). We then add expenditure on exports to the TDE and arrive at a measure known as **Total Final Expenditure**. It is so called because it represents the total of all spending on final goods. However, much of the final expenditure ison **imported goods** and we therefore **subtract spending on imports**. Having done this we arrive at a measure known as **gross domestic product at market prices**. To gross domestic product at market price we **subtract the taxes on expenditure** levied by the government and add on the
amount of subsidy. When this has been done we arrive at a figure known as **Gross Domestic Product at factor cost**. National Income however is affected by **rent**, **profit interest** and dividends paid to, or received from, overseas. This is added to GDP as net property income from abroad. This figure may be either **positive or negative**. When this has been taken into account we arrive at the gross national product at factor cost. As production takes place, the capital stock of a country wears out. Part of the gross fixed capital formation is therefore, to replace worn out capital and is referred to as **Capital Consumption**. When this has been subtracted we arrive at a figure known as the **net national product**. Thus, summarising the above, we can say:

\[ Y = C + I + G + (X - M) \]

**Calculating National Income from Total Expenditure**

<table>
<thead>
<tr>
<th>Country Y</th>
<th>National Expenditure (in £millions)</th>
<th>1999</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Expenditure of Consumers</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Food</td>
<td>27,148</td>
<td></td>
</tr>
<tr>
<td>Alcoholic drink</td>
<td>13,372</td>
<td></td>
</tr>
<tr>
<td>Tobacco</td>
<td>6,208</td>
<td></td>
</tr>
<tr>
<td>Housing</td>
<td>27,326</td>
<td></td>
</tr>
<tr>
<td>Fuel and light</td>
<td>9,395</td>
<td></td>
</tr>
<tr>
<td>Clothing</td>
<td>12,114</td>
<td></td>
</tr>
<tr>
<td>Household goods and services</td>
<td>12,274</td>
<td></td>
</tr>
<tr>
<td>Transport and communications</td>
<td>31,475</td>
<td></td>
</tr>
<tr>
<td>Recreation</td>
<td>16,541</td>
<td></td>
</tr>
<tr>
<td>Other goods and services</td>
<td>23,356</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>179,209</td>
<td></td>
</tr>
<tr>
<td>Less: Adjustment of non-profit making bodies</td>
<td>(443)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>178,766</td>
<td></td>
</tr>
<tr>
<td>Add: Expenditure of non-profit making bodies</td>
<td>3,661</td>
<td></td>
</tr>
<tr>
<td></td>
<td>182,427</td>
<td></td>
</tr>
<tr>
<td>Central Government expenditure</td>
<td>40,623</td>
<td></td>
</tr>
<tr>
<td>Local Government expenditure</td>
<td>25,236</td>
<td></td>
</tr>
<tr>
<td>Capital formation</td>
<td>49,559</td>
<td></td>
</tr>
<tr>
<td>Growth in stocks</td>
<td>267</td>
<td></td>
</tr>
<tr>
<td>Total Domestic expenditure at market prices</td>
<td>298,112</td>
<td></td>
</tr>
<tr>
<td>Deduct: Taxes on expenditure</td>
<td>(49,865)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>248,247</td>
<td></td>
</tr>
<tr>
<td>Add: Net result exports-imports</td>
<td>3,186</td>
<td></td>
</tr>
<tr>
<td>Subsidies</td>
<td>6,056</td>
<td></td>
</tr>
<tr>
<td>Net property income from abroad</td>
<td>1,948</td>
<td>11,190</td>
</tr>
<tr>
<td></td>
<td>259,437</td>
<td></td>
</tr>
<tr>
<td>Less: Estimated depreciation on capital assets</td>
<td>36,490</td>
<td>222,947m</td>
</tr>
</tbody>
</table>
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ECONOMIC GROWTH, ECONOMIC DEVELOPMENT AND ECONOMIC PLANNING

THE DIFFERENCE BETWEEN ECONOMIC GROWTH AND ECONOMIC DEVELOPMENT

**Economic Growth** is a narrower concept than economic development. It is an increase in a country's real level of national output which can be caused by an increase in the quality of resources (by education etc.), increase in the quantity of resources & improvements in technology or in another way an increase in the value of goods and services produced by every sector of the economy. Economic Growth can be measured by an increase in a country's GDP (gross domestic product).

**Economic development** is a normative concept i.e. it applies in the context of people's sense of morality (right and wrong, good and bad). The definition of economic development given by Michael Todaro is an increase in living standards, improvement in self-esteem needs and freedom from oppression as well as a greater choice. The most accurate method of measuring development is the Human Development Index which takes into account the literacy rates & life expectancy which affects productivity and could lead to Economic Growth. It also leads to the creation of more opportunities in the sectors of education, healthcare, employment and the conservation of the environment. It implies an increase in the per capita income of every citizen.

Economic Growth does not take into account the size of the informal economy. The informal economy is also known as the black economy which is unrecorded economic activity. Development alleviates people from low standards of living into proper employment with suitable shelter. Economic Growth does not take into account the depletion of natural resources which might lead to pollution, congestion & disease. Development however is concerned with sustainability which means meeting the needs of the present without compromising future needs. These environmental effects are becoming more of a problem for Governments now that the pressure has increased on them due to Global warming.

Economic growth is a necessary but not sufficient condition of economic development.
### Comparison

<table>
<thead>
<tr>
<th>Economic Development</th>
<th>Economic Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic development implies an upward movement of the entire social system in terms of income, savings and investment along with progressive changes in socioeconomic structure of country (institutional and technological changes).</td>
<td>Economic growth refers to an increase over time in a country’s real output of goods and services (GNP) or real output per capita income.</td>
</tr>
<tr>
<td>Development relates to growth of human capital indexes, a decrease in inequality figures, and structural changes that improve the general population's quality of life.</td>
<td>Growth relates to a gradual increase in one of the components of Gross Domestic Product: consumption, government spending, investment, net exports.</td>
</tr>
<tr>
<td>Qualitative.HDI (Human Development Index), gender-related index (GDI), Human poverty index (HPI), infant mortality, literacy rate etc.</td>
<td>Quantitative. Increases in real GDP.</td>
</tr>
<tr>
<td>Brings qualitative and quantitative changes in the economy</td>
<td>Brings quantitative changes in the economy</td>
</tr>
<tr>
<td>Economic development is more relevant to measure progress and quality of life in developing nations.</td>
<td>Economic growth is a more relevant metric for progress in developed countries. But it's widely used in all countries because growth is a necessary condition for development.</td>
</tr>
<tr>
<td>Concerned with structural changes in the economy</td>
<td>Growth is concerned with increase in the economy's output</td>
</tr>
</tbody>
</table>

### ACTUAL AND POTENTIAL GROWTH

Actual economic growth represents the fact that there is an actual increase in output; whereas potential economic growth represents an increase in the productive capacity of the economy.

Actual growth is defined as an increase in the output that an economy produces over a period of time, the minimum being two consecutive quarters. It economic growth is an increase in what an economy can produce if it is using all its scarce resources. An increase in an economy’s productive output can be shown by an outward shift in the economy’s production possibility frontier (PPF).

The simplest way to show economic growth is to bundle all goods into two basic categories, consumer and capital goods. An outward shift of a PPF means that an economy has increased its capacity to produce.
Potential growth is defined as the level of output that an economy can produce at a constant inflation rate. Although an economy can temporarily produce more than its potential level of output, that comes at the cost of rising inflation. Potential output depends on the capital stock, the potential labour force (which depends on demographic factors and on participation rates), the non-accelerating inflation rate of unemployment (NAIRU), and the level of labour efficiency.

THE BENEFITS AND COSTS OF GROWTH

Economic growth means an increase in real GDP. This increase in real GDP means there is an increase in the value of national output / national expenditure.

The benefits of economic growth include:

1. **Higher average incomes.** This enables consumers to enjoy more goods and services and enjoy better standards of living.
2. **Lower unemployment** With higher output and positive economic growth firms tend to employ more workers creating more employment.
3. **Lower government borrowing.** Economic growth creates higher tax revenues and there is less need to spend money on benefits such as unemployment benefit. Therefore economic growth helps to reduce government borrowing. Economic growth also plays a role in reducing debt to GDP ratios.
4. **Improved public services.** With increased tax revenues the government can spend more on public services, such as the NHS and education e.t.c.
5. **Money can be spent on protecting the environment.** With higher real GDP a society can devote more resources to promoting recycling and the use of renewable resources
6. **Investment.** Economic growth encourages investment and therefore encourages a virtuous cycle of economic growth.

Despite the benefits of economic growth, there are also potential costs, such as inflation, a current account deficit, environment costs and widening inequality.

However, the costs of economic growth will depend on the type of growth that we see.

Potential costs of economic growth include:

1. **Inflation.** If AD increases faster than AS then economic growth will be unsustainable. Economic growth tends to cause inflation when the growth rate is above the long run trend rate of growth. It is when demand increases too quickly that we get a positive output gap and firms push up prices.
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TOPIC 8

MONEY AND BANKING

MONEY

THE NATURE AND FUNCTIONS OF MONEY

The development of money was necessitated by specialization and exchange. Money was needed to overcome the shortcomings and frustrations of the barter system which is system where goods and services are exchanged for other goods and services.

Disadvantages of Barter Trade

- It is impossible to barter unless A has what B wants, and A wants what B has. This is called double coincidence of wants and is difficult to fulfill in practice.
- Even when each party wants what the other has, it does not follow they can agree on a fair exchange. A good deal of time can be wasted sorting out equations of value.
- The indivisibility of large items is another problem. For instance if a cow is worth two sacks of wheat, what is one sack of wheat worth? Once again we may need to carry over part of the transaction to a later period of time.
- It is possible to confuse the use value and exchange value of goods and services in a barter economy. Such a confusion precludes a rational allocation of resources and promotion of economic efficiency.
- When exchange takes place over time in an economy, it is necessary to store goods for future exchange. If such goods are perishable by nature, then the system will break down.
- The development of industrial economies usually depends on a division of labour, specialization and allocation of resources on the basis of choices and preferences.

Economic efficiency is achieved by economizing on the use of the most scarce resources. Without a common medium of exchange and a common unit of account which is acceptable to both consumers and producers, it is very difficult to achieve an efficient allocation of resources to satisfy consumer preferences.

For these reasons the barter system is discarded by societies which develop beyond autarky to more specialized methods of production. For such peoples a money system is essential.

Money may be defined as anything generally acceptable in the settlement of debts.
The Historical development of money

For the early forms of money, the intrinsic value of the commodities provided the basis for general acceptability: For instance, corn, salt, tobacco, or cloth were widely used because they had obvious value themselves. These could be regarded as commodity money.

Commodity money had uses other than as a medium of exchange (e.g. salt could be used to preserve meat, as well as in exchange). But money commodities were not particularly convenient to use as money. Some were difficult to transport, some deteriorated overtime, some could not be easily divided and some were valued differently by different cultures.

As the trade developed between different cultures, many chose precious metal’s mainly gold or silver as their commodity money. These had the advantage of being easily recognizable, portable, indestructible and scarce (which meant it preserved its value over time).

The value of the metal was in terms of weight. Thus each time a transaction was made, the metal was weighed and payment made. Due to the inconvenience of weighing each time a transaction was made, this led to the development of coin money. The state took over the minting of coins by stamping each as being a particular weight and purity (e.g. one pound of silver). They were later given a rough edge so that people could guard against being cheated by an unscrupulous trade filling the edge down.

It became readily apparent, however, that what was important was public confidence in the “currency” of money, it’s ability to run from hand to hand and circulate freely, rather than its intrinsic value. As a result there was deliberately reduced below the face value of the coinage. Any person receiving such a coin could afford not to mind, so long as he was confident that anyone to whom he passed on the coin would also “not mind”. Debasement represents an early form of fiduciary issue, i.e. issuing of money dependent on the “faith of the public” and was resorted to because it permitted the extension of the supply of money beyond the availability of gold and silver.

Paper Money

Due to the risk of theft, members of the public who owned such metal money would deposit them for safe keeping with goldsmiths and other reliable merchants who would issue a receipt to the depositor. The metal could not be withdrawn without production of the receipt signed by the depositor. Each time a transaction was made, the required amount of the metal would be withdrawn and payment made.

It was later discovered that as long as the person being paid was convinced the person paying had gold and the reputation of the goldsmith was sufficient to ensure acceptability of his promise to pay, it became convenient for the depositor to pass on the goldsmith’s receipt and the person being paid will withdraw the gold himself. Initially, the gold would be withdrawn immediately after the transaction was made. But eventually it was discovered that so long as each time a transaction was made the person being paid was convinced that there was gold, the signed receipt could change hands more than once. Eventually, the receipts were made payable to the bearer (rather than the depositor) and started to circulate as a means of payment themselves, without the
coins having to leave the vaults. This led to the development of paper money, which had the added advantage of lightness.

Initially, paper money was backed by precious metal and convertible into precious metal on demand. However, the goldsmiths or early bankers discovered that not all the gold they held was claimed at the same time and that more gold kept on coming in (gold later became the only accepted form of money). Consequently they started to issue more bank notes than they had gold to back them, and the extra money created was lent out as loans on which interest was charged. This became lucrative business, so much so that in the 18th and 19th centuries there was a bank crisis in England when the banks failed to honour their obligations to their depositors, i.e. there were more demands than there was gold to meet them. This caused the government to intervene into the banking system so as to restore confidence. Initially each bank was allowed to issue its own currency and to issue more currency than it had gold to back it.

This is called fractional backing, but the Bank of England put restrictions on how much money could be issued.

Eventually, the role of issuing currency was completely taken over by the Central Bank for effective control. Initially, the money issued by the Central Bank was backed by gold (fractionally), i.e. the holder had the right to claim gold from the Central Bank. However, since money is essentially needed for purchase of goods and services, present day money is not backed by gold, but it is based on the level of production, the higher the output, the higher is the money supply. Thus, present day money is called TOKEN MONEY i.e. money backed by the level of output.

Over time, therefore, it became clear that for an item to act as money it must possess the following characteristics.

• Acceptability

If money is to be used as medium of exchange for goods and services, then it must be generally accepted as having value in exchange. This was true of metallic money in the past because it was in high and stable demand for its ornamental value. It is true of paper money, due to the good name of the note-issuing authority.

• Portability

If an item is to be used as money, it must be easily portable, so that it is a convenient means of exchange.

• Scarcity

If money is to be used in exchange for scarce goods and services, then it is important that money is in scarce supply. For an item to be acceptable as money, it must be scarce.
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