UNIT 8

THE ECONOMIC REFORM PROGRAM IN ETHIOPIA

Unit Objectives

After completing this unit, you will be able to:

- state the main elements of the New Economic Reform and its important aspects in Ethiopia;
- examine structural adjustment policy measures undertaken in Ethiopia; and
- understand investment policy in Ethiopia.

Main Contents

8.1 THE NEW ECONOMIC POLICY AND THE NEED FOR REFORM

8.2 PERFORMANCE OF THE ECONOMY AFTER THE NEW ECONOMIC REFORM PROGRAM

8.3 INVESTMENT POLICY AND CLIMATE IN ETHIOPIA DURING THE POST-1991 PERIOD

- *Unit Summary*
- *Review Exercise*

INTRODUCTION

From our discussions in the previous units, you have learned about, among other things, the resource base of the country, the structure performance, and constraints of the three important sectorial components of the country: the agriculture, industry and service sectors. You are also learned that the economy has shown no structural transformation for the last three decades or so. Structural transformation refers to the transition from traditional agricultural to modern manufacturing activity.

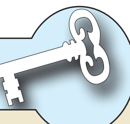
It has been documented that, as indicated by socio-economic indicators, Ethiopia appears to be one of the poorest countries in the world. To reverse this image, a number of economic reforms were taken by the government during 1990s. Hence, in this unit we will study the need for economic reform programs and the various reform measures taken by the government in the 1990s.

8.1 THE NEW ECONOMIC POLICY AND THE NEED FOR REFORM

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

- explain the new economic policy and the needs for reform.

Key Terms and Concepts



- Economic reform
- Investment
- Structural Adjustment Program (SAP)
- Consumption
- Saving
- Fiscal policy
- Economic growth

What is your understanding of the new economic reform taken by the current government?

In 1974/75 Ethiopia made a transition from a mixed economic system to a totally controlled economy that pushed the economy downward. During the central planned economy, the restrictions and taxation on the Ethiopian economy were substantial.

For instance, farmers in the main cereal growing areas had to supply a predetermined quota of grain to the government at a fixed low price and taxation levies on both rural and urban households were substantial factors of production. Also other markets were restricted, and rural wages and other market factors were repressed, and private sector developments were totally discouraged.

It has been documented that the per-capita income was birr 211.17 in 1973/74 and that it declined to 180.3 in 1990/91. In the mid 1980s, famine and war not only created a huge humanitarian disaster, but also pushed the economy farther back. In terms of growth rate, the average GDP growth rate was less than two percent (2%) in the period 1973/74-1990/91. Population, on the other hand, grew at about 2.9% in the same period, causing a deterioration in the living standard of the society at large. Military expenditures absorbed about 12-16 percent of the GDP, while the fiscal deficit increased from 11.9 percent in 1987/88 to 13.2% in 1990/91.

The poverty situation in the country was among the worst in the world. It has been documented that about 50% of the population in the country cannot afford the minimum food requirement. For instance, 52% of the rural and 36% of the urban population were unable to meet the minimum food requirement. This means that food poverty in rural areas was higher than in the urban ones. On top of this, 47% of the rural population and 33% of the urban population were found to be in absolute poverty.

Note

Absolute poverty is a state of poverty where an individual's daily income is below one dollar.

Furthermore, during the entire Military era, gross domestic saving was between 2.8% and 12.5% of the GDP, which was 14% of GDP in 1973/74. The public deficit became a huge burden on the economy, reaching 8.6 billion USD in 1990/91. The per-capita debt burden (356 birr) was far greater than the per-capita income of the country (18.3 birr).

The reason for the problematic performance of the economy was, among other things, due to:

- *mismanagement of economic resources,*
- *internal instability,*
- *recurrent drought, and*
- *poor performance of the agricultural sector.*

For instance, the annual growth rate of the agricultural sector averaged less than 2% during the Derg. Hence the agricultural sector was serously affected by the economic crisis, and it was totally incapable of protecting itself from the major economic collapse. Therefore, the performance of the Ethiopian economy progressively declined during the Derg.

This major economic collapse called for substantial reforms in the country. In order to lift the economy from its low level of development that had been caused by natural and human-made catastrophes as well as rigid macroeconomic policies, the Transitional Government of Ethiopian (TGE), which came into power on 28 May 1991, took steps to rehabilitate and reconstruct the war-damaged economy by adopting market-oriented economic policies scheme and stabilization and Structural Adjustment Program (SAP).

Note

Budget Deficit - is said to exist when government expenditure's in excess of government revenue.

Activity 8.1

Collect information on macroeconomic variables such as GDP and investment from relevant institutions and authorities.

8.1.1 Introduction to the Structural Adjustment Program

In response to the near collapse of the Ethiopian economy, coupled with unsustainable internal and external imbalances like the high inflation rate, negative interest rate and unviable debt ratio, the government of Ethiopia (GOE) in 1993 initiated a Structural Adjustment Program (SAP) for the period 1993-1996 with the support of the International Monetary Fund (IMF), World Bank (WB), African Development Fund (ADF) and other multilateral and bilateral donors.

The Structural Adjustment Program's refers to the reorganization of institutions, economic activities and the entire social system, in line with market-oriented economic systems. The overall goal of SAP was stabilization and adjustment. The stabilization policy focused on restoring macroeconomic balance and

reducing inflation and government budget, controlling the economy and the like. The Structural Adjustment Policy focused also on removing constraints on the supply side and pay a close attention to the production of export crops through depreciation of the real exchange rate and other incentives.

The Structural Adjustment Polices were also aimed at encouraging the development of the private sector, fostering competition throughout the economy and promoting the process of market determination of all prices, including exchange rates and interest rates. The main objectives of SAP include revival of economic growth, reducing macroeconomic distortion, improving economic efficiency and resource allocation and expanding the productive capacity of the economy.

Broadly speaking, the structural adjustment program has three components

- *Expenditure reducing policy*
- *Expenditure switching policy*
- *Institutional policy reform*

A ***Expenditure reducing policys:*** it is a policy of reducing spending level in the economy by adopting stringent monetary policies such as tight money supply, credit control and reducing public deficit. The aim of this policy is to curtail domestic demand so that demand-pull inflation can be prevented and domestic saving can be promoted.

B ***Expenditure switching policy:*** it is a policy of redirecting productive resources from nonproductive sectors to productive sectors or investments. Such a policy incorporates exchange rate devaluation, trade intervention, taxes, tariffs, and deregulation of price.

C ***Institutional policy reform:*** it is a policy of restructuring institutions towards competitiveness and efficiency through a market-oriented economy. The policy reform includes trade liberalization, privatization, reducing the state holdings in the economy, fiscal reform, financial market reform, and the like.

Note

Deregulation of prices refers to leaving the market price for commodities and factors of the production be determined by the market force of demand and supply without any government intervention.

8.1.2 Structural Adjustment Policy Measures Undertaken in Ethiopia

Ethiopia responded to the problem discussed in 8.1 by undertaking appropriate policy measures aimed at correcting imbalances in the economy, promoting the role of market forces in allocating resources, and removing impediments to the development of the private sector. The main policy measures for achieving the country's development objectives were:

1 Macroeconomic reforms include:

- *Monetary policy*
- *Exchange rate policy*
- *Fiscal policy and*
- *Interest rate policy*

Note

External Balance:- refers to an equilibrium achieved in the balance of payment.

A ***Monetary policy:*** the government of Ethiopia pursues a tight monetary policy to ensure consistency in money expansion with low inflation, rapid economic growth and external balances.

B ***Exchange rate policy:*** in 1992, a devaluation scheme was adopted to encourage exports and discourage imports. This helps to narrow the gap between export and import and thereby improve current account. It also helps to narrow the gap between official and black-market rates and abolish illegal trade in the country.

C ***Fiscal policy:*** is defined as the part of government economic policy which deals with taxation, expenditure, borrowing and the management of public debt in the economy. Such policy reform is undertaken to reduce fiscal deficit by greatly reducing government expenditure and expanding the tax base. At a time of depression and unemployment, the government should spend more than its revenue and thus insure a deficit in the budget.

D ***Interest rate policy:*** interest rate ceilings were abolished so as to enable it to reflect the state of the finical sector.

2 **Privatization:** with the objective of economic efficiency and profitability, a number of public enterprises have been privatized, and the process of privatization is still underway.

3 **Transport deregulation:** zonal restriction on transport service was abolished. To improve the financial performance of the sector, transport tariff rates have been revised.

4 **Domestic price liberalization:** price controls were abolished; prices of state-owned industrials and agricultural products were left to be determined by the market force of demand and supply.

5 **Foreign trade liberalization:** restrictions on trade were lifted by introducing a system of open general license. Export taxes on all commodities, except on coffee, were removed. Trade liberalization reacquird removal of import barriers inclining the replacement of quantitative restriction (quota) by tariffs whose rates are to be revised over time. Accordingly tariff rates have been revised and reduced.

6 **Private sector reform:** this measure is undertaken to encourage the participation of the private sector in the economic growth and development endeavors of the country. As a result the investment policy was revised in such a way as to promote both domestic and foreign investments and also to expand production activities and employment in the country. Absorption of foreign technology know-how and technical skills by Ethiopian entrepreneurs were also parts of the investment objective.

Activity 8.2

Discuss the major structural adjustment policy measures undertaken in Ethiopia.

Content Check 8.1

1 What does SAP mean?

2 What is the major objective of SAP?

3 List the three major components of SAP.

A ______________________________.

B ______________________________.

C ______________________________.

4 ___________ is a policy of redirecting productive resources from nonproductive sectors to productive sectors or investment.

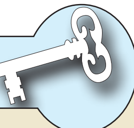
5 ___________ policy reforms trade liberalization and privatization.

8.2 PERFORMANCE OF THE ECONOMY AFTER THE NEW ECONOMIC REFORM PROGRAM

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

- evaluate the performance of the economy after the reform program.

Key Terms and Concepts



- Economic performance
- Government finance/investment
- Private sector/investment
- GDP growth
- Population growth
- Economic reform program

What is your opinion about the new economic reform program taken by the government?

The trend of economic growth for the period between 1960 and 1992 was unsatisfactory. This very dismal economic performance was caused by a number of factors, including rigid macroeconomic policies, protracted war, and recurrent droughts, which drained huge amounts of the country's resources and created a hostile external environment. The problem of the drought was the most severe of all.

It has been documented that the extent of drought varies from period to period, and that, between 1960 and 1992, drought and famine occurred at least nine times. The size and magnitude of rainfall has substantial effect on the performance of the entire economy, and so the above-mentioned drought conditions shrank the economy significantly.

Between 1963/64-1998/99, regardless of the policy regime, real GDP grew, on average, by 2.97%, while population grew, average, by 2.9%, resulting in a 0.06% (2.97%-2.91% = 0.06) annual growth rate per-capita income. This indicates that the economy had stagnated for the last three decades or so.

Table 8.1: **General government finance (in millions of birr)**

Year Indication	1989/90	1990/91	19991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998199
Total Revenue	3142.6	2706.7	2207.9	3191.2	3939.1	5912.8	6966.1	7877.4	8412.9	9413.8
Recurrent Expense	3842.6	3640.1	3253.5	3434.5	4399.6	5215.7	5582.3	5717.1	7081.4	8486.4
Capital Expense	14440-1	1214.1	951.8	1784.9	2694.3	3156.5	3562.6	4299.9	4146.6	4307.3
Total Expense	5382.0	4854.2	4205.3	5219.4	7093.9	8372.2	9144.5	10,017.0	11228.0	12793.7
Deficit	2140.4	2147.5	1997.4	2028.2	3154.8	2459.4	2178.8	2139.6	2815-1	3379.9

Source: *MEDAC (Ministry of Economic Development and Cooperation).*

From Table 8.1 you can see that the public sector deficit declined between 1989/90 and 1998/99, except in 1993/94 and 1998/99. In the latter years there was the Ethio-Eriteria war, which resulted in the highest recurrent expenditure. Thus, in the area of public deficit reduction, it can be concluded that the program was a success.

Table 8.2: **Average growth**

Sectorial period	Pre-program 1990/91-1992/93	Program 1993/94-1995/96	Post program 1996197-1998/99
Overall growth rate, real GDP	1.4	6.1	3.6
- Agriculture	2.9	4.8	0.9
- Industry	0.8	6.7	7.1
- Service	0.2	8.0	8.6

Source: *MEDAC (Ministry of Economic Development and Cooperation) year.*

From Table 8.2, notice that the average growth rate of agriculture decreased, the industry sector showed improvement, and the service sector increased rapidly in 1996/97 - 1998/99.

Table 8.3: **Demand-side indicators of economic performance**

Indicators	1980/81-1992/92	1992/93-19998/99
Aggregate consumption	93.4	97.0
Public consumption	16.1	13.0
Private consumption	77.3	81.0
Gross capital formation	13.6	16.3
Gross Domestic Saving (GDS)	6.7	6.3

Source: *National Bank of Ethiopia, (1999/2000).*

From Table 8.3, notice that the period of the reform program showed an improvement in all indicators except in GDS. A higher share in gross capital formation (GCF) was achieved due to the creation of an enabling environment, especially for the development of the private sector, and to the mobilization of available resources.

Table 8.4: **Private investment appraisal and implementation**

Fiscal year	Approved Investment		Commenced operation	
	Number	Million Birr	Number	Million Birr
1992/93	543	4082	123	1908
1993/94	523	3533	149	731
1994/95	686	5237	314	2525
1995/96	905	6514	399	2104
1996/97	794	6806	243	745
1997/98	894	10,093	194	629
1998/99	705	5205	69	141

Source: *Ethiopia Investment Authority, year.*

As shown in Table 8.4, all those measures aimed at developing the private sector bore fruit. The number of approved investment projects has risen rapidly even since the implementation of the program. A total of 50/50 projects were approved between 1992/93 and 1998/99 for a total amount of 41.5 billion birr, of which 1491 have actually commenced operation for a total amount of 8.8 billion birr. This trend is expected to accelerate as the privatization program moves into full capacity.

Activity 8.3

1. Collect some information from newspapers, radio or television that are related to Gross Domestic Product (GDP) and explain your conclusions in class.
2. Collect information related to an investment from newspapers or other different media and briefly explain the investment in class.

Content Check 8.2

1. What do you understand from Table 8.1? Explain in detail
2. What are the causes for the unsatisfactory results of the 1960 and 1992 economic reforms? Explain in detail.
3. Explain in detail the difference between private consumption and public consumption.

4 Explain briefly the indicators you use to assess the performance of the economy after the reform program.

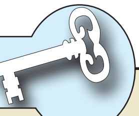
5 Explain in detail the reasons behind the implementation and approval of the government 50/50 projects.

8.3 INVESTMENT POLICY AND CLIMATE IN ETHIOPIA DURING THE POST-1991 PERIOD

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

- describe the investment policy and explain the investment climate in Ethiopia, post-1991.

Key Terms and Concepts



- Investment policy
- Investment areas
- Foreign investors
- Domestic investors
- Investment capital

What is your understanding of the investment policy taken by the current government?

It is widely known that the ancient country of Ethiopia underwent a period of turmoil, economic stagnation and famine during the 1970s and 1980s. In 1991, the Military government was replaced by the Transitional Government of Ethiopia with the introduction of new political and economic policies. In terms of the economic reform policy, a new program was launched with one of its primary objective being to build an economy in which the private sector plays a leading role. To enhance the role of private investment in the development process, various policy measures have been taken by the government. The policy measures were designed to eliminate discrimination against the private sector and to create a conducive environment for private investment.

Investment Proclamation No. 15/1992 was issued as the first policy measure by the Transitional Government of Ethiopia (TGE) for the purpose of encouraging both domestic and foreign investment. This proclamation removed restrictions

on private investment and allowed for wide participation of the private sector. Several investment incentives were provided under Article 13 of the proclamation. The proclamation states that domestic and foreign investors shall be entitled to exemption of import and export related taxes and duties, income tax withholding and some other benefits. Further more the proclamation listed available investment opportunities in the country.

The investment areas that are reserved only for government are:

- *Defence*
- *Heavy industry*
- *Large-scale electrical and energy work*
- *Large-scale air and marine transportation*
- *Postal and telecommunication servicese.*

The minimum investment capital requirement for the private investors in the country was also indicated. In the proclamation foreign investors were required to have a minimum investment capital of $USD 500,000 and deposit in cash of not less than 25% of the investment capital. With regard to domestic investors, they were required to have a minimum capital of Ethiopian birr 250,000. However, it is stated that these minimum investment capital requirements could be lowered in areas of special interest such as technology and know-how.

Later, Proclamation No 15/1992 was revised as Proclamation No. 37/1996. The new proclamation solved the shortcomings of Proclamation No. 15/1992, by reducing the minimum capital requirement for foreign investors from the previous $USD 500,000 to as low as $USD 100,000 and by lifting off 25% of the cash deposit.

The new investment Proclamation No. 280/2002 amended by Proclamation No 375/2003 was enacted with a view to:

- *Encouraging and promoting the private sector in the economic development of the country.*
- *Widening the scope of participation of foreign investment.*
- *Creating a transparent and efficient system of investment administration; this investment proclamation provides that a foreign investor can investment either*

- *As a sole proprietor with full equity ownership or*
- *Jointly or in partnership with domestic investor(s) or the government*

The law also stipulates the following capital requirement:

- *A minimum capital of $USD 100,000 for a single investment project in cash and /or in kind for wholly foreign owned inventors.*
- *A minimum capital of $USD 50,000 in cash and /or in kind per project in areas of engineering, architecture, accounting and audit service projects or business management consultancy services.*

Content Check 8.3

1 What indicators do you use to assess the performance of the economy?

2 Explain in detail why the capital requirements for the foreign and local investor are different for same types of project.

3 List some of the views with which Proclamation No. 375/2003 was enacted.

A ______________________.

B ______________________.

C ______________________.

4 How much capital is required to invest in areas such as engineering, architecture, accounting and audit service projects or business-management consultancy services?

UNIT REVIEW

UNIT SUMMARY

- The three important sectorial components are agriculture, industry and service. In terms of the economy as a whole, the sectors have not shown any structural transformation for the last three decades. In an attempt to convert from traditional to modern manufacturing, Ethiopia made a transition from a pro-capitalist economy system to a totally controlled economy that pushed the economy downward In 1974/75. Famine and war created a huge humanitarian disaster.
- The poverty situation in the country was the worst, and 50% of the population could not afford the minimum food requirement.
- The transitional government, which came to power in 1991, took steps to rehabilitate and reconstruct the war-damaged economy by adopting a market-oriented economic policy and Structural Adjustment Program (SAP). Broadly speaking, the Structural Adjustment Program has three components: expenditure reducing policy, expenditure switching policy and institutional policy reform.
- The unsatisfactory performance of the economy was caused by poor macroeconomic policy, drought and war.
- The investment policy and climate in Ethiopia during the post-1991 period introduced new economic and political programs. An investment policy was implemented to encourage local and foreign investors.

REVIEW EXERCISE FOR UNIT 8

I ***Write "True" or "False" for each of the following.***

1. In 1974/75, Ethiopia made a transition from controlled economy to mixed economy.
2. The annual growth rate of the agricultural sector averaged greater than 5%.
3. Expenditure se policy is a policy of redirecting productive resources to non-productive sectors.
4. Private sector reform is undertaken to encourage the participation of the public sectors.
5. No investment areas are reserved for the government only.

II *Choose the best answer from the given alternatives.*

6 Which one of the following policies reduces the spending level in the economy by adopting a stringent monetary policy.

A Institutional policy
B Expenditure reducing policy
C Institutional policy reform
D Monetary policy

7 One of the following exists when government expenditures in excess of government revenue.

A Fiscal policy
B Monetary policy
C Absolute poverty
D Budget deficit

8 One of the following is the government economic policy which deals with taxation, expenditure, borrowing and management of public debt in the economy.

A Interest rate policy
B Exchange rate policy
C Fiscal policy
D Monetary policy

9 How much investment capital is required for foreign investors by Proclamation No 15/1992?

A $USD 500,000 and 25% deposit in cash
B $USD 100,000 and 25% deposit in cash
C $USD 250,000 and 25% deposit in cash
D $USD 100,000 and 30% deposit in cash

10 One of the following is a state of poverty where an individual's daily income is below one dollar.

A Absolute poverty
B Drought
C Shortage of rain
D Per-capita

III *Write the full form of the following.*

11 GDP
12 CBE
13 NBE
14 SAP
15 TGE

GLOSSARY

Actual investment – *the amount that firms do invest; equal to planned investment plus unplanned investment.*

Aggregate demand – *a schedule or curve that shows the total quantity of goods and services demanded (purchased)at different price levels.*

Aggregate demand – *aggregate supply model The macroeconomic model that uses aggregate demand and aggregate supply to determine and explain the price level and the real domestic output.*

Aggregate expenditures – *The total amount spent for final goods and services in an economy.*

Aggregate supply – *A schedule or curve showing the total quantity of goods and services supplied (produced) at different price levels.*

Annually balanced budget – *A budget in which government expenditures and tax collections are equal each year.*

Asset – *Anything of monetary value owned by a firm or individual.*

Average propensity to consume – *Fractional (or percentage) of disposable income that households plant to spend for consumer goods and services; consumption divided by disposable income.*

Average propensity to save – *Fraction (or percentage) of disposable income that households save; saving divided by disposable income.*

Average tax rate – *Total tax paid divided by total (taxable) income, as a percentage.*

Balance of payments *(see international balance of payments.)*

Balance-of-payments deficit – *The amount by which the sum of the balance on current account and the balance on capital account is negative in a year.*

Balance-of-payments surplus – *The amount by which the sum of the balance on current account and the balance on capital account is positive in a year.*

Bank deposits – *The deposits that individuals or firms have at banks (or thrifts) or that banks have at the Federal Reserve Banks.*

Barter – *A formal agreement among firms (or countries) in an industry to set the price of a product and establish the outputs of the individual firms (or countries) or to divide the market for the product geographically.*

Barter – *The exchange of one good or service for another good or service.*

Brain drain – *The emigration of highly educated, highly skilled workers form a country.*

Budget deficit – *The amount by which the expenditures of the Federal government exceed its revenues in any year.*

Budget surplus – *The amount by which the revenues of the Federal government exceed its expenditures in any year.*

Business cycle – *Recurring increases and decreases in the level of economic activity over periods of years; consists of peak, recession, through, and recovery phases.*

Central bank – *A bank whose chief function is the control of the nation's money supply; in the United States, the Federal Reserve System.*

Ceteris paribus assumption *(see otber-tbings-equal assumption.)*

Change in demand – *A change in the quantity demanded of a good or service at every price; a shift of the supply curve to the left or right.*

Change in supply – *A change in the quantity supplied of a good or service at every price; a shift of the supply curve to the left or right.*

Circular flow model – *The flow of resources from households to firms and of products form firms to households. These flows are accompanied by reverse flows of many from firms to households and from households to firms.*

Classical economics – *The macroeconomic generalizations accepted by most economists before the 1930s that led to the conclusion that a capitalistic economy was self-regulating and therefore would usually employ its resources fully.*

Command system – *A method of organizing an economy in which property resources are publicly owned and government uses central economic planning to direct and coordinate economic activities; command economy.*

Commercial bank – *A firm that engages in the business of banking (accepts deposits, offers checking accounts, and makes loans).*

Comparative advantage – *A lower relative or comparative cost than that of another producer.*

Competition – *The presence in a market of independent buyers and sellers competing with one another and the freedom of buyers and sellers to enter and leave the market.*

Consumer goods – *Products and services that satisfy human wants directly.*

Consumer prices index (CPI) – *An index that measures the prices of a fixed "market basket" of some 300 goods and services bought by a "typical" consumer.*

Consumption of fixed capital – *An estimate of the amount of capital worn out or used up (consumed) in producing the gross domestic product; also called depreciation.*

Consumption schedule – *A schedule showing the amounts households plan to spend for consumer goods at different levels of disposable income.*

Corporate income tax – *A tax levied on the net income (profit) of corporations.*

Credit – *An accounting item that increases the value of an asset (such as the foreign money owned by the residents of a nation).*

Currency – *Coins and paper money.*

Current account –*The section in a nation's international balance of payments that records its exports and imports of goods and services, its net investment income, and its net transfers.*

Cyclical deficit – *A Federal budget deficit that is caused by a recession and the consequent decline in tax revenues.*

Cyclical unemployment – *A type of unemployment caused by insufficient total spending (or by insufficient aggregate demand).*

Cyclically balanced budget – *The equality of government expenditures and net tax collections over the course of a business cycle; deficits incurred during periods of recession are offset by surpluses obtained during periods of prosperity (inflation).*

Debit – *An accounting item that decreases the value of an asset (such as the foreign money owned by the residents of a nation).*

Demand – *A schedule showing the amounts of a good or service that buyers (or a buyer) wish to purchase at various prices during some time period.*

Demand curve – *A curve illustrating demand.*

Demand factor (in growth) – *The increase in the level of aggregate demand that brings about the economic growth made possible by an increase in the production potential of the economy.*

Demand-pull inflation – *Increases in the price level (inflation) resulting from an excess of demand over output at the existing price level, caused by an increase in aggregate demand.*

Dependent variable – *A variable that changes as a consequence of a change in some other (independent) variable; the "effect" or outcome.*

Determinants of aggregate demand – *Factors such as consumption spending, investment, government spending, and net exports that, if they change, shift the aggregate demand curve.*

Determinants of aggregate supply – *Factors such as input prices, productivity, and the legal-institutional environment that, if they change, shift the aggregate supply curve.*

Determinants of demand – *Factors other than price that determine the quantities demanded of a good or service.*

Determinants of supply – *Factors other than price that determine the quantities supplied of a good or service.*

Devaluation – *A decrease in the governmentally defined value of a currency.*

Discretionary fiscal policy – *Deliberate changes in taxes (tax rates) and government spending by Congress to promote full employment, price stability, and economic growth.*

Disinflation – *A Reduction in the rate of information.*

Dissaving – *spending for consumer goods and services in excess of disposable income; the amount by which personal consumption expenditures exceed disposable income.*

Domestic output – *Gross (or net) domestic product; the total output of final goods and services produced in the economy.*

Domestic price – *The price of a good or service within a country, determined by domestic demand and supply.*

Double taxation – *The taxation of both corporate net income (profits) and the dividends paid from this net income when they become the personal income of households.*

Dumping – *The sale of products below cost in a foreign country or below the prices charged at home.*

Earnings – *The money income received by a worker; equal to the wage (rate) multiplied by the amount of time worked.*

Economic analysis – *The process of deriving economic principles from relevant economic facts.*

Economic cost – *A payment that must be made to obtain and retain the services of a resource; the income a firm must provide to a resource supplier to attract the resource away from an alternative use; equal to the quantity of other products that con not be produced when resources are instead used to make a particular product.*

Economic growth *(1) An outward shift in the production possibilities curve that results from an increase in resource supplies or quality or an improvement in technology; (2) an increase of real output (gross domestic product) or real output per capital.*

Economic law – *An economic principle that has been tested and retested and has stood the test of time.*

Economic model – *A simplified picture of economic reality; an abstract generalization.*

Economic perspective – *A viewpoint that envisions individuals and institutions making rational decisions by comparing the marginal benefits and marginal costs associated with their actions.*

Economic policy – *A course of action intended to correct or avoid a problem.*

Economic principles – Widely accepted generalizations about the economic behavior of individuals and institutions.

Economic profit – *The total revenue of a firm less its economic costs (which include both payments to resource suppliers and the opportunity costs of firm-owned resources); also called "pure profit" and "above-normal profit".*

Economic resources – *The land, labor, capital, and entrepreneurial ability that are used in the production of goods and services; productive agents; factors of production.*

Economic system – *A particular set of institutional arrangements and a coordinating mechanism for solving the economizing problem; a method of organizing an economy, of which the market system and the command system are the two general types.*

Economics – *The social science dealing with the use of scarce resources to obtain the maximum satisfaction of society's virtually unlimited economic wants.*

Employment rate – *The percentage of the labor force employed at time.*

Equilibrium price – *The price in a competitive market at which the quantity demand and the quantity demanded and the quantity supplied are equal, there is neither a shortage nor a surplus, and there is no tendency for price to rise or fall.*

Equilibrium price level – *The price level at which the aggregate demand curve intersects the aggregate supply curve.*

Excess reserves – *The amount by which a bank's or thrift's actual reserves exceed its required reserves; actual reserves minus required reserves.*

Excise tax – *A tax levied on the production of a specific product or on the quantity of the product purchased*

Expenditures approach – *The method that adds all expenditures made for final goods and services to measure the gross domestic product.*

External debt – *Private or public debt owed to foreign citizens, firms, and institutions.*

Factors of production – *Economic resources: land, capital, labor, and entrepreneurial ability.*

Final goods and services – *Goods and services that have been purchased for final use and not for resale or further processing or manufacturing.*

Firm – *An organization that employs resources to produce a good or service for profit and owns and operates one or more plants.*

Fiscal policy – *Changes in government spending and tax collections designed to achieve a full-employment and noninflationary domestic output; also called discretionary fiscal policy.*

Fixed exchange rate – *A rate of exchange that is set in some way and therefore prevented from rising or falling with changes in currency supply and demand.*

Foreign exchange control – *The control a government may exercise over the quantity of foreign currency demanded by its citizens and firms and over the rates of exchange in order to limit its out payments to its in payments (to eliminate a payments deficit)*

Frictional unemployment – *A type of unemployment caused by workers voluntarily changing jobs and by temporary layoffs; unemployed workers between jobs.*

Full employment *(1) the use of all available resources to produce want –satisfying goods and services; (2) situation in which the unemployment rate is equal to the full- employment unemployment rate and there is frictional and structural but no cyclical unemployment (and the real GDP of the economy equals its potential output).*

GDP – *Gap The amount by which actual gross domestic product falls below potential gross domestic product.*

General Agreement on Tariffs and Trade (GATT) – *The international agreement reached in 1947 in which 23 nations agreed to give equal and nondiscriminatory treatment to one another, to reduce tariff rates by multinational negotiations, and to eliminate import quotas. It now includes most nations and has become the World Trade organization.*

Gold standard – *A historical system of fixed exchange rates in which nations defined their currencies in terms of gold, maintained a fixed relationship between their stocks of gold and their money supplies, and allowed gold to be freely exported and imported.*

Government transfer payment – *The disbursement of money (or goods and services) by government for which government receives no currently produced good or service in return.*

Gross domestic product (GDP) – *The total market value of all final goods and services produced annually within the boundaries of the United States, whether by U.S. or foreign –supplied resources.*

Household – *An economic unit (of one or more person that provides the economy with resources and uses the income received to purchase goods and services that satisfy economic wants.*

Human capital – *the accumulation of prior investments in education, training, health, and other factors that increase productivity.*

Import demand curve – *A down sloping curve showing the amount of a product that an economy will import at each world price below the domestic price.*

Imports – *Spending by individuals, firms, and governments for goods and services produced in foreign nations.*

Income – *A flow of dollars (or purchasing power) per unit of time derived from the use of human or property resources.*

Income effect – *A change in the quantity demanded of a product that result from the change in real income (purchasing power) produced by a change in the product's price.*

Incomes approach – *the method that adds all the income generated by the production of final goods and services to measure the gross domestic product.*

Independent variable – *The variable causing a change in some other (dependent) variable.*

Indirect business – *taxes such taxes as sales, and business property taxes, license fees, and tariffs that firms treat as costs of producing a product and pass on (in whole or in part) to buyers by charging higher prices.*

Industry – *A group of (one or more) firms that produce identical or similar products.*

Inferior good – *A good or service whose consumption declines as income rises (and conversely), price remaining constant.*

Inflation – *A rise in the general level or prices in an economy.*

Information technology – *New and more efficient methods of delivering and receiving information through used of computers, fax machines, wireless phones, and the Internet.*

Infrastructure – *The capital goods usually provided by the public sector for the use of its citizens and firms (for example, highways, bridges, transit systems, wastewater treatment facilities, municipal water systems, and airports).*

Interest – *The payment made for the use of money (of borrowed funds).*

Interest rate – *The annual rate at which interest is paid; a percentage of the borrowed amount.*

Intermediate goods – *products that are purchased for resale or further processing or manufacturing.*

International balance of payments – *a summary of all the transaction that took place between the individuals, firms, and government units of one nation and those of all other nations during a year.*

International monetary reserves –*The foreign currencies and other assets such as gold that a nation can use to settle a payments deficit.*

Inverse relationship – *The relationship between two variables that change in opposite directions, for example, product price and quantity demanded.*

Investment – *Spending for the production and accumulation of capital and additions to inventories.*

Investment demand curve – *A curve that shows the amounts of investment demanded by an economy at a series of real interest rates.*

Invisible hand – *The tendency of firms and resource suppliers that seek to further their own self-interests in competitive markets to also promote the interest of society.*

Keynesian economics – *The macroeconomic generalizations that lead to the conclusion that a capitalistic economy is characterized by macroeconomic instability and that fiscal policy and monetary policy can be used to promote full employment, price-level stability, and economic growth.*

Labor – *Intensive commodity A product requiring a relatively large amount of labor to be produced.*

Labor – *People's physical and mental talents and efforts that are used to help produce goods and services.*

Labor productivity – *Total output divided by the quantity of labor employed to produce it.*

Land National resources ("free gifts of nature") – *used to produce goods and services.*

Law of demand – *The principle that, other things equal, an increase in a product's price will reduce the quantity of it demanded, and conversely for a decrease in price.*

Law of increasing opportunity costs – *the principle that as the production of a good increases, the opportunity cost of producing an additional unit rises.*

Law of supply – *The principle that, other things equal, an increase in the price of a product will increase the quantity of it supplied, and conversely for a price decrease.*

Legal tender – *Anything that government says must be accepted in payment of a debt.*

Liability – *A debt with a monetary value; an amount owed by a firm or an individual.*

Liquidity – *The ease with which an asset can be converted quickly into cash with little or no loss of purchasing powder. Money is said to be perfectly liquid, whereas other assets have lesser degrees of liquidity.*

Long run *(1) In microeconomics, a period of time long enough to enable producers of a product to change the quantities of all the resources they employ; period in which all resource and costs are variable and no resources or costa are fixed. (2) In macroeconomics, a period sufficiently long for nominal wages and other input prices to change in response to a change in e^th nation's price level.*

Marginal analysis – *The comparison of marginal ("extra" or "additional") benefits and marginal costs, usually for decision making.*

Marginal cost – *The extra (additional) cost of producing 1 more unit of output; equal to the change in total cost divided by the change in output.*

Marginal propensity to consume – *The fraction of any change in disposable income spent for consumer goods; equal to the change in consumption divided by the change in disposable income.*

Marginal propensity to save – *The fraction of any change in disposable income that household save; equal to the change in saving divided by the change in disposable income.*

Marginal utility – *The extra utility a consumer obtains from the consumption of 1 additional unit of a good or service; equal to the change in total utility divided by the change in the quantity consumed.*

Market – *Any institution or mechanism that brings together buyers (demanders) and seller (supplier)of a particular good or service.*

Market economy – *An economy in which only the private decisions of consumer, resource supplier, and firms determine how resources are allocated; the market system.*

Microeconomics – *The part of economics concerned with such individual units as industries firms, and households and with individual market, specific good and series, and product and resource prices.*

Monetary policy – *A central bank's changing of the money supply to influence interest rates and assist the economy in achieving price stability, full employment, and common growth.*

Monopoly – *A market structure in which the numbers and sellers is so small that each seller is able to influence the total supply and the price of the good or service.*

Multinational corporations – *Firms that own production facilities in two or more countries and produce and sell their products globally.*

National bank – *A commercial bank authorized to operate by the U.S. government.*

National income – *Total income earned by resource suppliers for their contribution to gross domestic product; equal to the gross domestic product minus non income charges, minus net foreign factor income.*

National income accounting – *The techniques used to measure to overall production of the economy and other related variables for the nation as a whole.*

Net domestic product – *Gross domestic product less the part of the year's output that is needed to replace the capital good worn out in producing the output; the nation's total output available for consumption or additions to the capital stock.*

Net exports – *Exports minus Imports.*

Net transfers – *The personal and government transfer payments made by one nation to resident of foreign nations less the personal and government transfer payments received from residents of foreign nations.*

Nominal gross domestic product (GDP) – *The GDP measured in terms of the price level at the time of measurement (unadjusted for inflation).*

Nominal income – *The number of dollars received by an individual or group for its resources during some period of time.*

Nominal wage – *The amount of money received by a worker per unit of time (hour, day, etc.); money wage.*

Oligopoly – *a market condition in which a few firms dominate production of a particular type of good or service and have a substantial degree of interdependence.*

Opportunity cost – *the value of the second-best choice that is given up when a first choice is taken.*

Partnership – *a business organization that is owned by two or more individuals under a contractual agreement.*

Patent – *a document registering a new product or process with the government, making it illegal for others to use this product or process for a specified period of time, usually 17 years.*

Personal-income – *the amount of income that household receive due to their own productivity and from other sources.*

Point of equilibrium – *the point where a product's demand and supply curves meet, which indicates the product's equilibrium price.*

Positive balance of trade – *the situation resulting when the value of a nation's exports exceed the value of its imports.*

Price elasticity of demand – *the relationship between a change in price and the resulting change in the quantity of a product that is sold.*

Price-elastic demand – *the type of demand that exists when a change in a product's price results in a larger relative change in the quantity that is sold.*

Price-inelastic demand – *the type of demand that exists when a change in a product's price results in a smaller relative change in the quantity that is sold.*

Prime interest rate – *the rate of interest charged by banks to large business customers.*

Producer price index (PPI) – *a measure of inflation similar to the CPI except that it is based on the cost of roughly 2,500 resources typically purchased by businesses in the factor market.*

Production – *the creation of goods or services.*

Profit – *what results when a firm's revenues are greater than its costs.*

Progressive tax – *a tax that takes a larger share of a person's income as his or her earnings grow.*

Proportional tax – *a tax that takes the same percentage of all people's income.*

Protective tariff – *a tax on an imported good or service that is primarily intended to protect a nation's businesses from a foreign competition.*

Public good – *a government-provided product that is available to all members of a community on equal bases.*

Quota – *a limit on the quantity of a product that may be imported into a country.*

Real GDP – *the value of the GDP adjusted for a change in price, expressed in constant dollar.*

Recession – *a period of time when the level of economic activity is lower than the average trend over time.*

Regressive tax – *a tax that takes a smaller share of a person's income as his or her earnings grow.*

Revenue – *income received.*

Revenue tariff – *a tax on an imported good or service that is primarily intended to generate income for a nation's government.*

Scarcity – *a condition in which it is impossible to satisfy all human wants for goods and services; the central concept in economics.*

Service – *an intangible action that is capable of satisfying human wants.*

Short run – *a period of time that is not long enough for a firm to change the size of its physical plant.*

Specialization – *concentrating labor on a particular task to increase productive efficiency.*

Stagflation – *an economic state in which production is stagnant or falling and prices are increasing.*

Structural unemployment – *layoffs of workers because they lack skills that would them to be employed.*

Substitute goods – *related goods that may be used interchangeably; an increase in the price of one will cause an increase in the quantity demanded of the other, even if its price remains the same.*

Supply – *the quantity of a good or service that firms will offer for sale at each possible price.*

Supply curve – *a graph indicting the product quantities that will be supplied at different possible prices.*

Supply schedule – *a table indicating the product quantities that will be supplied at different possible prices.*

Tariff – *a tax on an imported good or service that increase the price consumers must pay for imported products and therefore discourages their sales.*

Tastes and preferences – *personal feelings toward the value or desirability of various products.*

Three central economic questions – *the basic decisions that must be made in all economic systems; what goods and services should be produced, how these goods and services should be produced, and for whom these goods and services should be produced.*

Time lag – *the time it takes government to form and implement economic policy.*

Total cost (TC) – *the sum of a firm's fixed and variable costs.*

Total physical product (TPP) – *the total quantity of products a firm is able to produce from a given quantity of resources.*

Total revenue – *the amount of income a firm generates from its sales; price times quantity sold.*

Total utility – *the utility that is derived by a person from all the units of a particular product that he or she owns.*

Trade-off – *the act of choosing one alternative at the expense of another.*

Transfer payments – *payments of money by the government to people for social reasons rather than compensation for labour or products.*

Unemployed – *a term describing workers who are over 16, are not institutionalize, and have actively looked for work but are not able to find employment.*

Unit-elastic demand – *the type of demand that exists when a change in the price of a product results in an equal relative change in the quantity sold.*

Utility – *a measure of the value of a good or service.*

Value-added tax – *a tax on the additional value that firms add to the products they produce.*

Variable costs (VC) – *costs that change with the number of products a firm makes or offers for sale.*

Velocity – *the speed at which money circulates through the economy.*

Yield – *the percentage of return a financial instrument pays on its price.*