COVENANT UNIVERSITY

TUTORIAL KIT

PROGRAMME: ECONOMICS

OMEGA SEMESTER

100 LEVEL

Raising A New Generation Of Leaders

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ECN 121: INTRODUCTION TO ECONOMICS II (MACRO)

COVENANT UNIVERSITY

CANAANLAND, KM 10, IDIROKO ROAD
P.M.B 1023, OTA, OGUN STATE, NIGERIA.

TITLE OF EXAMINATION: B.Sc. EXAMINATION
COLLEGE: CBSS
SCHOOL: SSS
DEPARTMENT: ECONOMICS AND DEVELOPMENT STUDIES
SESSION: 2014/2015 **SEMESTER: OMEGA**
COURSE CODE: ECN 121 **CREDIT UNIT:** 2
COURSE TITLE: INTRODUCTION TO ECONOMICS II
INSTRUCTION: ANSWER QUESTION ONE&ANY OTHER TWO QUESTIONS.
TIME: 2 HOURS

1a. (i)Given the following model, $Y = C + I + G$

$C = a + bY$

Derive the aggregate expenditure multiplier. (2 marks)

(ii) Given the model

$C = 50 + 0.75Yd$

$I = 120$; $G = 100$; $T = -80$

Calculate the level of equilibrium national income. (5 marks)

(b). Given the following hypothetical prices and quantities of two goods and services from 2012 to 2014, calculate the following.

i) Nominal GDP ii) Real GDP iii) GDP deflator (6 marks)

Year	Quantity of indomie	Price of indomie	Quantity of bread	Price of bread
2012	1000	N1	500	N2
2013	2500	N2	1000	N3
2014	3600	N3	1500	N4

c)The mathematical approximation called the rule of 72 shows the effect of compounding of economic growth rate over time.

i) In view of the rule stated above, calculate the number of years it will take income to double if it is rising each year by 2, 3 and 6 per cent. (3 marks)

ii) Which country would have higher income in 36 years: country A that begins with income of $3,000, increasing at an annual rate of 4 percent a year or country B that begins with income of $6,000, increasing at an annual rate of 2 percent a year? Which will have higher income in 72 years? (4 marks)

d) i) State three costs of economic growth and suggests ways to overcome them. (5 marks)

ii) Sketch and briefly explain both the positive and normative methods of macroeconomic analysis. (5 marks)

2a. Explain the following concepts with respect to international trade:
(i) Absolute advantage (ii) Commercial policies (iii) Subsidies (6 marks)
b) Briefly explain three (3) gains from trade (4 marks)
c) Highlight four (4) arguments for protectionism in International Trade (5 marks)
d) Use an appropriate diagram to explain the movement of money and goods in a two-sector economy (5 marks)

3a.ii) Identify and explain the causes of unemployment. (5 marks)
ii) State four costs unemployment imposes on a society (2 marks)

iii) Define natural unemployment and state four sources. (3 marks)

3b. i) Identify and explain the different types of inflation. (5 marks)
ii) What are the possible effects of inflation and how can they be remedied? (5 marks)

4a. i) Define fiscal policy and state its uses. (5 marks)

ii) Sate five limitations of fiscal policy. (2.5 marks)

4b. i) Define monetary policy and discuss three instruments used. (5 marks)

4b. ii) Present a hypothetical data set of a macroeconomic variable that is in an undesiredstate and briefly explain how an identified monetary policy tool can be used to address it (7.5 arks)

5a. State the basic premise and implication of the following theories of consumption (10 marks)

i. Absolute income hypothesis
ii. Permanent income hypothesis
iii. Relative income hypothesis
iv. Life time income hypothesis

b. Given that the consumption function is: $C = a + bY$. Derived the savings function. (3 marks)

c. List and explain two objective and two subjective determinants of savings. (7 marks)

ECN121 Marking Guide

Marking Guide for my part of the exam questions

2a (i) Absolute Advantage

Whenever a country can produce a particular good more efficiently (by using fewer resources) than, others, we say the country has an absolute advantage over the other in the production of the good. For example, assuming that Ghana and Nigeria produces wine, but Ghana`s climatic conditions and its labour force are more suitable for the production of wine. It follows that Ghana will produce more wine than Nigeria, using the same amount of resources. We therefore say that Ghana enjoys an absolute advantage over Nigeria in the production of wine.

(ii) Commercial Policies

Commercial Policies are policies of the government directed at influencing the volume of the country`s trade with other nations through the uses of taxes/subsidies or through direct restrictions on imports and exports. These restrictions-also called `obstacles to trade`- take several forms. The three most common types of trade restrictions are tariffs, subsidies and quotas.

(iii) Subsidies

Export subsidies are employed by the government to encourage domestic firms to produce more for exports. This happens when government decides to take responsibility for some of the cost of producing the goods (in relation to only those exported). Hence, export subsidies serves to keep domestic prices high, but assists in flooding the world market with subsidized goods.

(6 marks)

2b Gains From Trade

1. Specialisation : Because nations produce those goods in which they have comparative advantage, they soon become specialised in the production of goods.

2. Acquisition of Technology: Developing countries acquire technological know-how while interacting with technologically advanced nations through trade.

3. Efficient Utilization of Resources : Exporting countries try their utmost to produce goods that are intentionally acceptable by utilizing available resources efficiently.

4. Healthy Competition and World Peace : International trade encourages healthy competition among producing nations and promotes world peace.

5. Economies of Scale: Countries with production advantages and capacity for mass production of some products benefits from large-scale production and trade.

(4 marks for any three (3) explained)

2c Arguments for Protection

There are several arguments usually advanced in support of trade barriers. These include

(a) Job Protection

A major argument for protection is that foreign competition could cost the citizens of the importing countries their jobs by transfering demand from domestic to foreign-produced good especially when the import price of the commodity is lower than the domestic cost of production.

(b) National Security

Certain products may have to be developed to meet exigencies such as war even when a nation do not have obvious absolute or even comparative advantage in it`s production. For example, the steel industry is very vital to the survival of any economy.

(c) Protection of `infant` industries

Young industries usually require protection from heavy competition

(d) Tariffs for revenue

Tariffs are introduced to boost government revenue and not as a protective device. This is so when duties are levied on imported goods for which there is no substitute in domestic production e.g imported cars.

(e) Unfair Trade practices of other Countries

Trade protection is often employed by nations to protect themselves or as retaliatory measure against unfair trade practices by other nations.

(5 marks for any four (4) explained)

3a. (i) **<u>Identify and Explain the Causes of Unemployment in Nigeria.</u>**

<u>a. Technological change</u>: In an economy when there are new products, new industries, new opportunities for some, reduced opportunities for others. Restructuring, downsizing, and outsourcing have created new opportunities, new jobs, but eliminated other jobs. Economy is changing as we move into the Information Age and as international competition intensifies. **(1 Mark)**

<u>b. Shifts in public sector priorities</u>: When there are shifts in public sector priorities by the government leading to entrenchment or laying off of workers, this will result in unemployment in Nigeria. For examples at the end of Civil War or during Regulation or Deregulation may create unemployment as there is reduction on defense spending, recruitment of personnel and changes in industries which unemployment. **(1 Mark)**

c. Limited information: Workers may not be aware of all of the jobs available and employers may not be aware of all of the qualified employees. Information is costly and imperfect. Because workers and employers don't have access to perfect information, there is some unemployment due to the lack of complete information. This means that unemployment occurs as a result of the time required to match production activities with qualified resources. **(1 Mark)**

d. Economic downturn: When there is general decline in macroeconomic activity, especially expenditures on gross domestic product in a country that occurs during a business-cycle contraction. When the economy dips into a contraction, or recession, aggregate demand declines, so less output is produced and fewer workers and other resources are employed. That is temporary unemployment due to recession from reduced demand for labor during an economic downturn. **(1 Mark)**

e. Seasons: Unemployment arises when there are regular and predictable declines in particular industries or occupations over the course of a year, often corresponding with the seasons of the year. Many construction workers face unemployment during winter months. School teachers face unemployment during the summer months. The employment of farm workers varies with seasonal planting and harvesting activities. **(1 Mark)**

3a. (ii)**State four costs unemployment imposes on a society(2 Marks)**

i)Economic Costs

ii) Psychological Costs

iii) Social Costs

iv)Personal Costs

iii)**Define Natural Rate of Unemployment and State Four Sources (3 Marks)**

Natural Rate of Unemployment: The natural rate of unemployment is unemployment that does not go away on its own even in the long run. It is the amount of unemployment that the economy normally experiences.

It can also be defined as the average rate of unemployment around which the economy fluctuates.

Four Sources:

i)**Availability of job information**. A factor in determining frictional unemployment

ii)**Skills and Education.** The quality of education and retraining schemes will influence the level of occupational mobilities.

iii)**Degree of labour mobility**

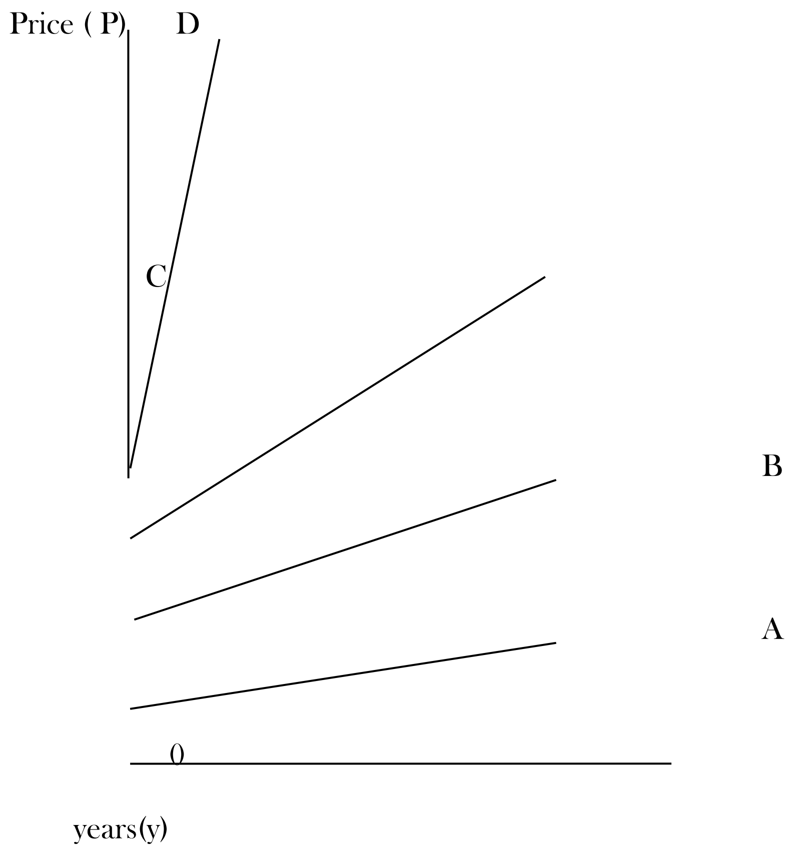
iv)**Flexibility of the labour market** E.g. powerful trades unions may be able to restrict the supply of labour to certain labour markets

v) Hysteresis. A rise in unemployment caused by a recession may cause the natural rate of unemployment to increase. This is because when workers are unemployed for a time period they become deskilled and demotivated and are less able to get new jobs.

3b.)

i) **Identify and explain the different types of inflation(5 Marks)**

1. Creeping inflation: when prices rise at a very slow rate and the annual inflation rate is within range 0f 1 to 3 per annum or less than 3 per cent. At this rate people do not feel the impact thus it is regarded as safe and essential for economic growth.
2. Walking inflation: when prices rise moderately and the annual inflation rate is a single digit. In other words, the rate of rise in prices is in the intermediate range of 3 to 7 per cent per annum or less than 10 per cent. Inflation at this rate is a warning signal for the government to control it before it turns into running inflation.
3. Running inflation: when prices rise rapidly and the annual inflation rate is a double digit. In other words, the rate of rise in prices is in the range of 10 to 20 per cent per annum. Inflation at this rate affects the poor and middle class adversely. Government will have to make use of strong monetary and fiscal measures in order to control to before it turns in hyperinflation.
4. Hyperinflation: this is also known as galloping or runaway inflation. It is a period when prices rise very fast at double or triple digits rates from more than 20 to 100 per annum or more. This occurs during or soon after a war, when government spending increases tremendously resulting in money rapidly lose its value or ability to buy goods. In reality, it is a situation where the rate to inflation becomes immeasurable and absolutely uncontrollable. Hyperinflation is usually seen when a country is having a very serious political problem such as war or famine. e.g. during the Biafra war in Nigeria, Ghana in the 1970s, In Uganda during Idi Amin era.
5. Stagflation: it is simply the simultaneous occurrence of high unemployment *and* high inflation which plagued the economy in the 1980s.



- The diagram above illustrates the speed with which prices tend to rise. The curve A shows creeping inflation when within a period of ten years the price level risen minimally (30 %). The curve B depicts walking inflation when the price rose by say more than 50 per cent during the past ten years. The curve C illustrates running inflation showing a rise of about 100 per cent in ten years. The curve D shows the path of hyperinflation when prices rose by more than 120 per cent in less than one year.

3b.ii)What are the possible effects of inflation and how can they be remedied?

(5 Marks)

Possible Effects of Inflation

a) It encourages business people to invest their capital in productive enterprise. New industries are established and existing ones are expanded which results in increase in number of people employed.

b) Inflation affects people living on fixed incomes and those who have saved certain amounts of money for their retirement badly. That is, it leads to undesirable redistribution of income and reduces the standard of living of those living on fixed income.

c) Inflation can affect foreign trade in two ways. Firstly, it raises export prices thereby making the demand for exportable goods to fall in the international market. Secondly, it could spur rising of prices of certain items imported into the domestic economy as a result of inflation in one's trading partner economy.

d) During inflationary period, price of basic goods tends to raise thus encouraging investors to expand their production line to take advantage of rising prices, thereby increasing their profits.This will lead to increase in employment of factor resources especially labour.

e) Borrowers and lenders: Debtors gain during inflation as they are able to liquidate their debts easily as money borrowed back then as lost its value when compared to now. Lenders suffer a loss because the real value of repaid debts has been adversely affected by inflation.

<u>Remedies</u>

i. Increasing output: since inflation occurs because supply falls short of demand for goods and services then if supply is increased, price will fall. Increasing output is therefore an effective way of controlling inflation.
ii. Government can control inflation by reducing the volume of purchasing power. People demand for goods and services due to increase in their purchasing power caused by too much money in circulation which leads to increased spending.
iii. Encouraging growth of the need sector to increase output of goods and services produced at home.
iv. Government can make use of monetary or fiscal measures to control inflation.

5 A.

Consumption theory	**Basic premise (1 point, 1 mark)**	**Implication (1 point, 1 mark)**
Absolute income hypothesis	Consumption is a rising function of current income	Rich countries will save a greater share of their income than poor countries A country will save a greater share of its income as it grows richer. A policy of income redistribution which reduces income inequality, will be expansionary
Relative income hypothesis	Consumption is a function of relative income in an income distribution	Demonstration effects, ratchet effect (tendency to maintain previous consumption levels)
Permanent income hypothesis	Consumption is a function of past, present and future income; that is income and consumption have transitory components	Individuals will like consume in relation to their permanent income over a planning horizon of 3-5 years If the increase in income is not considered permanent (i.e. transitory) consumption behaviour is not affected
Lifetime/life cycle income hypothesis	Consumption is a function of lifetime income;	Middle-aged people have a relatively low propensity to consume in relation to young people and old people.

	Individuals will likely consume in relation to their lifetime income over a planning horizon of a lifetime	Therefore, consumption is determined by income and wealth

Q5 b.. Given that the consumption unction is: C = a + bY. Derived the savings function. (4 marks)

A. C= a + bY -------(1)

Recall,

Y=C+S -----------(2) (1 mark)

S = Y – C

But C = a + bY (1 mark)

S = Y – (a+bY)

S= Y – a – bY

Collecting like terms

S = – a +Y – bY (1 mark)

S = – a + (1 – b) Y ....Savings function (1 mark)

Check: MPS + MPC = 1

MPC = b, MPS = 1 – b

MPC+MPS = b + 1 – b =1

Q5 c . List and explain two objective and two subjective determinants of savings. (4 marks)

A. Subjective determinants of savings (2 marks)

i. Instinct for precaution: People with instincts to hold money for precautionary motives are likely to save more than those who do not. This in turn affects the aggregate level of savings
ii. The desire for bequest: People with a desire to leave an inheritance for their children and children's children tend to save more than those without such desires. This in turn affects the aggregate level of savings

iii. Habits: A population with a cultivated habit of saving will save more than a consuming population without saving cultivated habits.
iv. Cultural factors: Some cultural beliefs customs and norms can influence savings behaviour, hence the incidence of saving

Objective determinants of Savings (Measurable/Quantifiable) (2marks)

i. Income level: The higher the income the higher the savings
ii. Interest rate: Higher interest rates on savings can stimulate higher savings
iii. Inflation rate: Higher inflation rates tends to lower savings and savings rate

Availability of saving facility: Higher numbers of available savings infrastructure, the higher saving