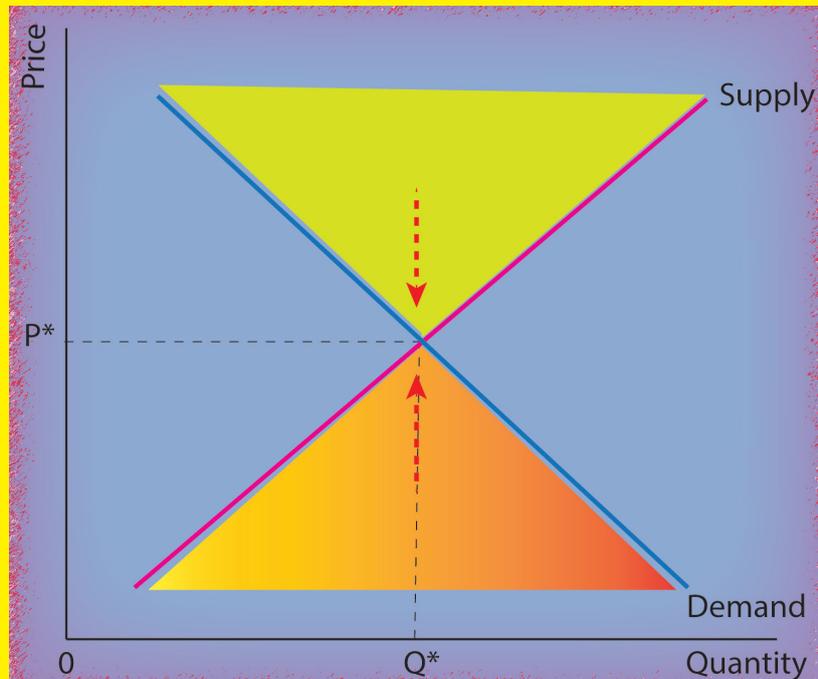




ECONOMICS
Grade 10
Distance Module II



FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA
MINISTRY OF EDUCATION



ECONOMICS

Distance Module II

GRADE 10

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FEDERAL DEMOCRATIC REPUBLIC OF ETHIOPIA
MINISTRY OF EDUCATION



HAWASSA UNIVERSITY

First Published **xxxxxx** 2023 by the Federal Democratic Republic of Ethiopia, Ministry of Education, under the General Education Quality Improvement Program for Equity (GEQIP-E) supported by the

World Bank, UK's Department for International Development/DFID-now merged with the Foreign, Common wealth and Development Office/FCDO, Finland Ministry for Foreign Affairs, the Royal Norwegian Embassy, United Nations Children's Fund/UNICEF), the Global Partnership for Education

(GPE), and Danish Ministry of Foreign Affairs, through a Multi Donor Trust Fund.

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The Ministry of Education wishes to thank the many individuals, groups and other bodies involved – directly or indirectly – in publishing this Textbook. Special thanks are due to Hawassa University for their huge contribution in the development of this textbook in collaboration with Addis Ababa University, Bahir Dar University, Jimma University and Semera University.

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Printed by:

xxxxxxx PRINTING

P.O.Box xxxxxx

xxxxxxx, ETHIOPIA

Under Ministry of Education Contract no. xxxxxxxxxxxx

ISBN:_____

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Module Introduction

Dear Distance learner! Hello and welcome to the course on economics. In developing these materials, we took your needs, prior knowledge, and experiences into account.

This module is organized into four units. The first Unit deals with Theories of Banking and Finance, with in which you will learn various concepts from the Financial Intermediaries up to the role of indigenous financial institutions such as “Iqub” and “Idir”. The second Unit deals with the theories and measurements of Economic Growth with in which you will learn various economic growth concepts, from explaining how to measure economic growth to discussing about productivity, measurements in economics. The third unit deals with discussing the overview of the Ethiopian Economy in which various economic situations in Ethiopia will be discussed, from the main sectors of the Ethiopian economy up to being able to write a brief report on Ethiopian economy. The fourth unit deals with Innovation and business startups in which you will learn various business concepts, from defining the term innovation up to conducting a strength, weakness, opportunity, and threat (SWOT) analysis of an existing enterprise. Each unit of the module consists of interrelated sections that are divided into a number of sub-sections. You are expected to complete this module in a total of 1560 hours.

As you go through the materials, there are unit outcomes and competencies stated at the beginning of each unit and section. Please read the materials thoroughly in order to achieve the stated objectives after completing your study of the intended unit or sections.

When you read the materials, you will see questions. They provide you with opportunities to apply your previous knowledge. These text-based questions also have motivational value. Try to answer them in order to develop critical thinking.

There are self-check tasks at the end of each section that allow you to assess your understanding of the topics covered in relation to the objectives provided at the beginning of the section.

The final task of each section is a self-test. Try to respond to them without consulting your notes. At the conclusion of each module, the answers to the exercises and the self-test will be provided. After finishing them, compare your response to the answer key provided at the end of the module. Fill them out and submit them to your tutor.

Icons in the Module

Throughout each module, you will find the following icons or graphic symbols that alert you to a change in activity within the module. Only the icons that are required are used in each module.

 Text or Reading Material	provides information about the topics that are covered.
 Self-check	requests that you double-check your comprehension. If you mark any box under the 'No' column, please look at the corresponding item to the left and go back to your text and read about it.
 Summary	highlights or provides an overview of the most important points covered.
 Overview	introduces you to focus on the content that will be discussed.
 Suggested Answers	allows you to evaluate your learning by providing sample answers to assessments and activities
 Objective	indicates what you should know after completing a section or unit.
 Self-Assessment	enables you to check your understanding of what you have read and, in some cases, to apply the information presented in the unit to new situations.
 In text Question.	
 Recall for prior learning	requires you to focus on the content that will be discussed in a section or unit

Unit 1

Banking and Finance



Unit Introduction

One of the basic factors of production in economics is capital. Capital is the amount of money the producer pays for the other factors of production (labor, land and entrepreneur) used in the production process.

Banks are one of the financial institutions that are used to transfer finance from those who have it in excess to those who need it. People with excess money will go to finance and put it in banks; this is called saving. People who are short on cash will go to the bank and request loans. Banks will lend money according to their lending procedures. This activity of banks is one example of financial intermediation.

Thus, in this unit, the issues that will be discussed concerning banks and other financial intermediaries are an introduction to financial intermediaries, an introduction to financial markets, financial institutions, banking and non-banking financial institutions, the historical development of the banking sector in Ethiopia, electronic banking (e-banking), and indigenous financial institutions in Ethiopia (ikub and "iddir). Therefore, students are expected to think of banks and other financial intermediaries in their locality and their functions as savers of excess money and as lenders to those who need the money.



Unit Outcomes

By the end of this unit, you will be able to.

- ◆ Discuss the different types of financial intermediaries.
- ◆ Describe the financial institutions (banks, microfinance institutions, and indigenous institutions).
- ◆ Analyze the role of indigenous financial institutions.
- ◆ Identify financial institutions and their historical development in Ethiopia (Banks, Microfinances and Indigenous institutions).
- ◆ Evaluate the roles of financial institutions for the socio-economic improvement of society.
- ◆ Explain electronic banking.

The required study time for this unit is 15 Hours.

Unit Learning Strategies

Dear distance learner, remember each unit has a self-study format. The following learning strategies will help you study this unit.

- Reading the topics
- Doing various activities
- Completing written exercises
- Activities based on the learner's experience
- Extra-curricular learning
- Scenario-based activity
- Auto tutorial instruction

1.1 Introduction to Financial Intermediaries



Overview

In this section, you will learn about financial intermediation. Capital/ Finance is a very significant input in the process of production. Thus, you will learn about the role of financial institutions such as banks in acting as financial intermediary between those who deposit finance/money and those who borrow finance/money.



Learning outcomes

By the end of this section, students will be able to.

- Define financial intermediation.
- Mention the roles financial intermediaries.
- List the benefits of financial intermediaries.

Key Concepts

Finance; financial intermediaries; saving; borrowing; banks; microfinance institutions



Start Up Activity

Think of financial institutions (e.g banks) in your town. List out their benefits for the people in the town?



A Financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, for instance, the Commercial Bank of Ethiopia. Financial intermediaries offer a number of benefits to the average consumer, such as safety, liquidity, and economies of scale involved in banking and asset management.

In other words, financial intermediaries mediate between the providers (with excess money) and users (with a shortage of money) of financial capital. The transfer of funds from a surplus spending unit to a deficit spending unit through financial intermediaries is also called financial intermediation.

What are the benefits of financial intermediaries?

For depositors, financial intermediaries provide safety and interest earnings. Safety refers to the fact that the money of the depositors is free from any risk of loss. Banks also pay interest

on the money saved at their banks by the depositors.

These are the benefits that financial intermediaries provide to depositors.

For the Borrowers- People who borrows money from banks and other financial intermediaries are known as investors. In the process of production, they may face a shortage of finance and go to financial intermediaries (e.g., Banks) to get money or finance for their investment. The financial intermediaries will charge them annual interest on the money they borrow. The more money they borrow, the more investment (production) they undertake, which is useful for the country.

Thus, finance (money) in the economy is like the blood circulating in the body. Any economy or country cannot function well without money (finance), just as the body cannot function without blood circulating in it. We use it to buy our day-to-day needs (demand = willingness + Ability; where ability is the money or finance, we have).

Activity 1.1

1. What is financial mediation?
2. Differentiate between financial intermediaries and financial intermediation?
3. What roles do financial intermediaries play between the providers and users?
4. List out the financial intermediaries in your town.



Self-test exercise 1.1

Dear distance learner, please differentiate between financial intermediaries and financial intermediation. Did you try? Great job!



Suggested Answers

1. Financial intermediaries are individuals (money lenders) or institutions (banks, microfinance institutions) who lend money to those in need. To get the loan and savings services, one should register at the financial institutions and fulfill the lender and saver criteria.

This process of saving and lending money is called financial intermediation.

2. *Examples* of financial intermediaries include friends and relatives, banks, microfinance institutions, iqubbs and iddirs, etc.

Dear Distance learner, you can provide real-life examples from your area.

For instance, names of banks, names of microfinance institutions, names of IDDIRs, names of IQUBs, etc. that you know from your area.

1.2 Introduction to Financial Markets



Overview

This section teaches you about one of the very crucial markets in economics. In this market finance/money will be transacted (bought and sold) at market price of the price of money, i.e., interest rate. In this section, you will learn about this market.



Learning outcomes

By the end of this section, students will be able to;

- ◆ Describe financial markets.
- ◆ Identify the components of financial markets.
- ◆ Examine the different money market instruments in their surroundings.
- ◆ Mention bank loan forms in Ethiopia.

Key Concepts

Financial Markets; Money Markets; Capital Markets; Investment



Start Up Activity

What comes to your mind when you think of financial markets?



Financial markets are markets that provide channels for the allocation of savings to investment. They provide a variety of assets to savers as well as various forms in which investors can raise funds and thereby decouple the acts of saving and investment. Savers and investors are constrained not by their own abilities, but by the economy's ability to invest and save. The financial markets, thus, contribute to economic development to the extent that it depends on the rates of savings and investment.

The financial markets have two major components.

- i. Money market
 - ii. Capital market
- A. Money market- According to Drake and Fabozzi (2010), money market is the sector of the financial market that includes financial instruments with a maturity date of one year or less at the time of issuance. Money market instruments include.
- Treasury bills,
 - Commercial papers,
 - Negotiable certificates of deposit,
 - Repurchase agreements, and
 - Bankers' acceptances.

- i. Treasury Bills- are financial instruments issued by governments with maturity dates of

three weeks, one month, three months, or six months. The holder of a T-Bill realizes a return by buying these securities for less than their maturity value and then receiving the maturity value at maturity.

- ii. **Commercial papers-** are promissory notes— written promises to pay—issued by a large, creditworthy corporation or a municipality with an original maturity that ranges from one (1) day to two hundred seventy (270) days. Commercial paper may be either interest-bearing or sold on a discounted basis.
- iii. **Certificates of deposit (CDs)-** are written promises by a bank to pay a depositor. They are issued by large commercial banks with original maturities between one month and one year. On the maturity date, the issuer repays the principal, plus interest.

B. The capital market- is the sector of the financial market where long-term financial instruments are issued by corporations and governments. They have an original maturity greater than a year and perpetual securities (those with no maturity). There are two types of capital market securities.

- A. Equity and
- B. Debt Obligations

C. Equity- is a capital market financial instrument that includes *common stock* and *preferred stock*. Common stock represents ownership of a perpetual corporation, and hence, common stock is a *perpetual security*. Preferred stock also represents ownership interest in a perpetual corporation but can either have a redemption (maturity) date or be perpetual.

D. Debt Obligation- is a capital market financial instrument whereby *the borrower promises to repay the maturity value at a specified period of time beyond one year*. They include.

- Bank loans and*
- Debt securities.*

Bank Loans- One form of such a bank loan is a *syndicated bank loan*. This is a loan in which a group (or syndicate) of banks provides funds to the borrower.

Debt securities- a *debt security with a maturity at issuance of 10 years or less(Notes)*; and those with a maturity greater than 10 years (*bonds*).



Activity 1.2

1. What are financial markets?
2. What are the components of the financial markets?
3. What money market instruments are available in your area?
4. List some examples for each component of financial markets.
5. Are bank loans available in Ethiopia? Mention some of them.



Self-test exercise 1.2

Dear distance learner, please define financial markets and list its components giving examples for each component. Did you try? Great job!



Suggested Answers

1. Financial markets are places or situations where financial instruments/assets are traded.
2. Components of financial markets are. money markets & capital markets
3. *Examples include. money markets-* short-term treasuries (e.g., T-bills), certificates of deposit (CDs), commercial paper, repurchase agreements (repos), and money market mutual funds; *capital markets-* the New York Stock Exchange, American Stock Exchange, London Stock Exchange, and NASDAQ.

1.3 Introduction to Financial Institutions



Overview

Banks and microfinance institutions are major financial institutions. These institutions directed by the national/central bank of countries will bring equilibrium between the demand and supply in the financial markets. In such a way, they can either aggravate or calm the inflationary pressure of countries. In this section you will learn about these financial institutions.



Learning outcomes

By the end of this section, you will be able to;

- ◆ Explain financial institutions and their major types.
- ◆ Describe formal and informal financial institutions
- ◆ Explain the banking system and its roles in the economy.
- ◆ Elaborate treasury bills and their roles.
- ◆ Analyze non-banking financial institutions in their surroundings

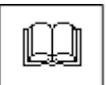
Key Concepts

Institutions; financial institutions; indigenous financial institutions; microfinance institutions; formal institutions; informal institutions



Start Up Activity

What comes to your mind when you think of financial institutions?



Institutions are norms that organize social, political, and economic relations. They are 'the underlying rules of the game' in any society or organization. There are two forms of institutions.

- Formal and informal.

The written constitution, laws, policies, rights, and regulations enforced by official authorities are examples of formal institutions.

Informal institutions, on the other hand, are the usually unwritten social norms, customs, or traditions that shape thought and behavior.

What are financial institutions?

Financial institutions are *institutions that serve as financial intermediaries*.

There are *three* major types of financial institutions.

- i. *Depository Institutions*- Deposit-taking institutions that accept and manage deposits and make loans. Example- *banks and credit unions*.
- ii. *Contractual Institutions*- Insurance companies and pension funds; and
- iii. *Investment Institutions*- Investment Banks, underwriters, brokerage firms.

1.3.1 The Banking Financial Institution

A bank is a financial intermediary *that gives money (loan) to a borrower*. They also accept deposits from depositors. The banking sector, as an intermediary in any economy, has a major role to play in enhancing development and growth through its activities of.

- (a) Mobilizing saving,
- (b) Identifying good investment and
- (c) Exerting through sound corporate control, particularly during the early stages of economic development and in a weak institutional environment.

Accordingly, the banks' roles in an economy include;

1. Obtaining information about companies and managers in order to improve capital allocation and corporate governance.
2. Managing cross-sectional, inter-temporal, and liquidity risks and thereby enhancing investment efficiency and economic growth.

As an institution, the efficiency of a bank depends on the following two key factors.

- 1) Degree of competition that exists among banks and,
- 2) The nature of the regulation to which banks are subject to.

It is believed that competition among banks in the economy will result in.

- ✓ Greater technical efficiency within deposit institutions,
- ✓ Lower interest rates for borrowers,
- ✓ Higher interest rates for depositors and
- ✓ A greater variety of services

1.3.2 The Non- Banking Financial institution

A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency.

NBFIs facilitate bank-related financial services- such as investment, insurance, risk pooling, contractual savings, and market brokering.

Examples include insurance companies, pawn shops, cashier's check issuers, check cashing locations, payday lending, currency exchanges, and microloan organizations.



Activity 1.3

1. What are financial institutions?
2. What are the major types of financial institutions?
3. What are the components of financial institutions?
4. What role do banks play or have in society?
5. What are treasury bills?
6. Is there any non-banking financial institution in your area? Give examples.



Self-test exercise 1.3

Dear distance learner, please summarize financial institutions, its components, roles banks play in the society and treasury bills. Did you try? Great job!



Suggested Answers

1. *Definition-* Financial institutions (FIs) are companies engaged in the business of dealing with financial and monetary transactions such as deposits, loans, investments, and currency exchange.
2. *Components of financial institutions/system.* Five Basic Components of Financial System- 1. Financial Institutions, 2. Financial Markets, 3. Financial Instruments (Assets or Securities), 4. Financial Services and 5. Money.
3. *Bank's roles of in Society-* Banks operate by borrowing funds-usually by accepting deposits or by borrowing in the money markets. ... Through the process of taking deposits, making loans, and responding to interest rate signals, the banking system helps channel funds from savers to borrowers in an efficient manner.

Definition- T-bills - issued with short term maturities (in Ethiopia we have 1-month, three-month, six month and twelve-month maturity periods). They offer investors the lowest yield of all government bond issues. Similar to zero- coupon bonds, T-bills are auctioned off to investors at a discount to par.

1.4 Historical Development of Banks in Ethiopia



Overview

In Ethiopia modern banking started in 1905 with the establishment of Abyssinian Bank. The establishment was based on a fifty-year agreement with the Anglo-Egyptian National Bank. This section will teach you this and other historical development of banks in Ethiopia.



Learning outcomes

By the end of this section, students will be able to.

- Describe the historical development of banks in Ethiopia
- Examine the roles and functions of various banks in Ethiopia
- Give practical examples of the functions of banks in their environment.

Key Concepts

Socialist economy System; Financial Liberalization



Start Up Activity

How old is the oldest Bank in Ethiopia?

A Historical Note

In Ethiopia modern banking started in 1905: with the establishment of Abyssinian Bank, based on a fifty-year agreement with the Anglo-Egyptian National Bank.

In 1908: a new development bank (called Société Nationale d' Ethiopie Pour le Development de l'Agriculture et du Commerce) and two other foreign

1.4.1 History of Banking in Ethiopia

i. 1905 - 1931

It was Emperor Menelik II (King of Ethiopia) that introduced modern banking in Ethiopia. There was an agreement signed between the King and the British owned National Bank of Egypt. The first modern bank, Bank of Abyssinia, was founded in 1906 as a result of this agreement. The Bank was totally managed by the Egyptian National Bank, a foreign bank. (National Bank Of Ethiopia, 2020/21).

According to (Mauri, 2003), The Bank was given a 50- years concession and was engaged in issuing notes, collecting deposits and granting loans, but its clients were mostly foreign businessmen and wealthy Ethiopians.

In the following couple of years after its foundation, Bank of Abyssinia opened branches in different towns of the country. Accordingly, the bank had opened branches in the following towns of the country.

- Harar town (1906)
- Dire Dawa town (1908)

- Gore Town (1912) and
- Dessie and Djibouti (1920)

Bank of Abyssinia was liquidated in 1931. (Mauri, 2003). According to (Nwanne, 2019), The Bank was a private bank whose shares were sold in Addis Ababa, New York, Paris, London, and Vienna. The Bank financed the Franco-Ethiopian Railway project which reached Addis Ababa in 1917.

ii. **1931 to 1936**

In 1931, Bank of Abyssinia was liquidated and legally replaced by **Bank of Ethiopia** shortly after Emperor Haile Selassie came to power.

The new bank, the Bank of Ethiopia, was totally under Government control and retained the management, the staff, the premises and the clients of the previous bank, Bank of Abyssinia. (Mauri, 2003). Thus, the bank of Ethiopia became the first independent bank of Ethiopia, which was totally under Ethiopian government control.

Bank of Ethiopia took over *the commercial activities of the Bank of Abyssinia* and was *authorized to issue notes and coins*. The bank keeping the branches of the previous bank, added;

- *Agency in Gambella and a transit office in Djibouti.*

It was, however, short lived and was liquidated during the Italian occupation in 1936. (Mauri, 2003).

iii. **1936-1941**

The following new banks were introduced by the Italians during their invasion of the country (Ethiopia) from 1936 – 1941.

- *Banca d'Italia,*
- *Banco di Roma,*
- *Banco di Napoli and*
- *Banca Nazionale del lavoro*

These were actually branches of the main Italian banks in Italy. They had branches which operated in the main towns of Ethiopia during the five year occupation period. Only Banco di Roma and Banco di Napoli (which were operating in Asmara) continued their operation after 1941.

iv. **1941 - 1943**

There was another foreign bank introduced in 1941 (**Barclays Bank**) *with the coming of the British troops and they organized banking services in Addis Ababa, until its early withdrawal in 1943.*

v. **1943 - 1963**

The **State Bank of Ethiopia** was established in 1943 as the *central Bank of Ethiopia* with a power of issuing bank notes and coins as the agent of the Ministry of Finance. The Bank functioned as the principal commercial bank in the country and engaged in all commercial

banking activities besides issuing bank notes and coins. (National Bank Of Ethiopia, 2020/21) According to (Mauri, 2003), the establishment of the **State Bank of Ethiopia**, marked the rebirth of the Ethiopian independent banking. The bank was doing all the banking activities as the only bank. commercial banking activities (providing loans and taking deposits) and central bank activities (issuing bank notes and coins). Until 1963, the State bank was the Central bank of the country.

The **State Bank of Ethiopia** had established 21 branches including a branch in *Khartoum, Sudan and a transit office on Djibouti* until it ceased to exist by bank proclamation issued on December, 1963.

vi. **1963 – 1974**

According to (Nwanne, 2019), The National Bank of Ethiopia was established in 1963 by Proclamation number 206 of 1963 and began operation in January 1964. This proclamation "The previous State Bank of Ethiopia" into two banks. National Bank of Ethiopia and Commercial Bank of Ethiopia.

In 1963, the Ethiopian government split the State Bank of Ethiopia (est. 1942) into the National Bank of Ethiopia, the Central Bank, and the Commercial Bank of Ethiopia (CBE). The government later merged Addis Bank into the Commercial Bank of Ethiopia in 1980 to make CBE the sole commercial bank in the country. The government had created Addis Bank from the merger of the newly nationalized Addis Ababa Bank, and the Ethiopian operations of Banco di Roma and Banco di Napoli. Addis Ababa Bank was an affiliate that National and Grindlays bank had established in 1963 and of which it owned 40%. At the time of nationalization, Addis Ababa Bank had 26 branches.

vii. **From 1974 to 1991**

Following the declaration of socialism in 1974, the government extended its control over the whole economy and nationalized all large corporations. Accordingly, *the three private owned banks.*

- *Addis Ababa Bank,*
- *Banco di Roma and*
- *Banco di Napoli*

Were combined (Merged) in 1976 and formed the second largest Bank in Ethiopia called.

1. *Addis Bank*

Then, in 1980, Addis Bank and Commercial Bank of Ethiopia S.C. were merged /combined to form the sole Commercial bank in the country till the establishment of private commercial banks in 1994.

The *Commercial Bank of Ethiopia* commenced/started its operation with a capital of Birr 65 million, 128 branches and 3,633 employees, in the year 1980.

The *Agricultural and Industrial Bank* was formed in 1970 as a 100 percent state ownership, and which was under the umbrella of the National Bank of Ethiopia. *Then after, in 1979, the bank was renamed Agricultural and Industrial Development Bank (AIDB). It was entrusted*

with the financing of the economic development of the agricultural, industrial and other sectors of the national economy extending credits of medium and long-term nature as well as short-term agricultural production loans (National Bank Of Ethiopia, 2020/21).

The financial sector constituted only three (3) banks and each enjoyed monopoly power in its respective market. The following was the three dominant banks in the country during 1974 -1991 period (according to the Gregorian calendar). This period was also known as the Socialist period in Ethiopian history.

- The National Bank of Ethiopia (NBE)
- The Commercial Bank of Ethiopia (CBE)
- Agricultural and Industrial Development Bank (AIDB)

viii. **From 1991 to _**

In 1991 the country became a liberal economy system. The National Bank of Ethiopia (NBE) outlined its main functions separated from the previous total government control. The Licensing and supervision of Banking Business was formulated in 1994. (Monetary and Banking Proclamation No. 83/1994). The proclamation laid down the legal basis for investment in the banking sector.

1.4.2 Roles and Functions of Banks in Ethiopia

A. National Bank of Ethiopia (NBE)

National bank of Ethiopia, just like other countries' national or central banks, control interest rates, manage the amount of credit available, and control the amount of money supply.

National Bank of Ethiopia, on behalf of the government, controls and regulates the activities of the financial sector, the commercial banks, insurance companies and microfinance institutions.

Commercial banks generate profit by depositing money, borrowing money from the national bank, and lending money to the public. National banks, however, are not profit making banks, rather they control the overall financial sector in the country. The objective of controlling the financial sector is to bring price stability or control inflation.

The following are the various roles that it plays to control the financial sector and bring price stability in the country.

- It prints the currency and mints the coins;
- Issues bonds, treasury bills, and promissory notes on behalf of the government;
- Maintains low levels of inflation;
- Authorizes and controls micro and other financial institutions;
- Deposits government money and provides direct advances to the government;
- Lends money to commercial banks;
- Regulates the money supply, interest rates and other charges,
- Controls the creation of credit by commercial banks;

- Formulates the monetary policy framework for the country;
- Manages the international reserve of the country;
- Regulates the foreign exchange of the country.

B. Commercial Bank of Ethiopia (CBE)

The Commercial Bank of Ethiopia is the biggest and the leading commercial bank in the country.

The current Commercial Bank of Ethiopia (CBE) was the result of the merging of Addis Bank S.C and the former commercial bank of Ethiopia 1980.

As a government commercial bank, the bank has the following Roles and Functions mandated to it by the NBE.

- Saving/deposit for the households/individuals and firms;
- Gives loans to households and firms;
- Provides safe custody for valuables for households/individuals;
- Sell and purchase foreign currencies;
- Issue letters of credit (LC), traveler's cheques, etc.;

C. Development Bank of Ethiopia (DBE)

The development bank of Ethiopia (DBE) is one of the financial institutions engaged in providing short, medium and long term development credits/loans. It has a "project" based lending tradition. Project financed by the Bank are carefully selected and prepared through appraised, closely supervised and systematically evaluated.

Specifically, the Development Bank Of Ethiopia (DBE), which took this last name in 1994 financial reform is mandated with the following roles in the country.

- 1) Provides loans for the development of the agricultural and industrial sectors;
- 2) Supervises and controls the activities of projects financed by the bank;



Activity 1.4

1. Summarize about the historical development of banks in Ethiopia
2. Summarize the economic advantages of having more private commercial banks in Ethiopia?
3. List out as many roles and functions of the following banks to the society.
 - i. National Bank of Ethiopia (NBE)
 - ii. Commercial Bank of Ethiopia (CBE)
 - iii. Development bank of Ethiopia (DBE)



Self-test exercise 1.4

Dear distance learner, please summarize the historical development of banks, advantages of having more commercial banks and the roles of the different types of banks in the

country. Did you try? Great job!



Suggested Answers

1. After learning the sections about the historical development, each should tell the other a story of at least one bank. Please facilitate this.
2. More funds will be available for lending and investment.
3. Major functions of the following banks.
 - a. NBE- over all supervision of the banking sector and money supply.
 - b. CBE- taking deposits and providing loans.
 - c. DBE-provide loan for development projects.

1.5. Micro-finance institutions



Overview

The conventional banking financial institution lends money for collaterals only. This lending system fails when in the African and other developing countries case of no collateral. In this case microfinance institutions were invented to solve this problem of lack of collaterals. This section teaches you about this very crucial financial institution.



Learning outcomes

By the end of this section, students will be able to;

- ◆ Distinguish between micro-financing and micro-crediting
- ◆ List microfinances in their locality
- ◆ Analyze clients of microcredit in their surroundings and mention features of money lenders.
- ◆ Examine the difference between moneylenders and microfinance institutions.
- ◆ Give examples of microfinance institutions in Ethiopia.

Key Concepts

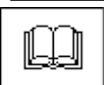
Microfinance; Microcredit; Group collateral; Loan default



Start Up Activity

Where do you think the poor go to get credit (loan)?

#Hint. Banks ask for collaterals (assets to be held) to give loans!



State-run banks had already tried to provide loans to poor households in different countries in the world. But, they only left a legacy of inefficiency, corruption, and millions of dollars of wasted subsidies. Thus, providing loans to the poor with no collateral was an issue for so many years until Mohammed Yunus (Bangladeshi Economist born in 1940) came with

a noble winning idea of microfinancing and microcredit, resulting in the establishment of the Grameen Bank.

Muhammad Yunus started making small loans to local poor villagers with no collateral and could not get loans from the formal traditional banks. He believed that his poor clients would make profits and be able to pay back the loans reliably.

Today microfinance institutions serve millions of poor people in different countries in the world. They provide small/micro loans without collateral, collecting deposits, and, increasingly, selling insurance, all to customers who had been written off by commercial banks as being unprofitable. Advocates see the changes as a revolution in thinking about poverty reduction and social change, and not just a banking movement. (Armendáriz & Morduch, 2010).

1.5.1 Microfinance and Microcredit

Microfinance institutions (MFIs)- are financial institutions that give access to financial services such as *savings, credit, insurance and money transfer* to people that otherwise would remain un-served by the traditional banking system that asks for collaterals. What makes microfinance (-ing) different from other anti-poverty tools is the idea that it improves the living conditions of the poor through their own efforts. It gives “micro-credit” to support “microbusinesses” allowing low-income people to respond to economic opportunities. For them the main constraint is a small investment in working capital, and microcredit allows overcoming this obstacle. The purpose of these organizations is the provision of financial services to those who would otherwise be excluded from the formal financial system.

A microcredit- is a small credit given to a client by a microfinance institution. Microcredit is offered, *often without collateral*, to an individual through group lending mechanism. Group lending is a mechanism that allows a number of individuals to obtain a loan through a group scheme. The group is taken as collateral in this case. The incentive to repay is based on peer pressure; if one person in the group defaults, the other group members must make up the payment amount.

Microcredit has been proven an effective tool against poverty, enabling those without access to the formal financial system to borrow the small amount of funds they need and start or develop small businesses.

Micro-entrepreneurs, or *economically active poor*, are business people who through microfinance take advantage of economic opportunities that otherwise would remain unserved due to *financial constraints*.

Microfinance institutions (MFIs) give not only microcredit, however, but also other financial services like saving service, insurance service and money transfer service that improve the well-being of the poor and helps poor people to stabilize income and to protect against risks.

1.5.2 Clients of Microfinance

The clients of microfinance are the “economically active poor” or low-income persons that do not have access to formal financial institutions. This “economically active poor” clients of microfinances must have economic opportunities and entrepreneurial skills as the money they receive must not be used for consumption but for productive purposes. The “poorest of the poor”, or “the destitute”, are generally excluded from the circle of microfinance and targeted by other development programs, because they don't have economic opportunities or entrepreneurial skills.

Group lending mechanism has been proven to be a good option for lending the money to the economically active poor. In this mechanism, each member of the group is guarantee/collateral for the other. The effectiveness and sustainability of group lending mechanism depends on the strength of social ties and the influence of peer pressure in the society.

1.5.3 Microfinance and Money Lenders

Informal moneylenders are the more direct competitors of microfinance institutions (MFIs). The interests charged in informal moneylenders almost always far exceed what is charged by MFIs and borrowers do not have any kind of protection from abusive behaviors, e.g., abusive lending or unfair loan collection practices. The informal moneylenders most of the time lend money to the poor who has no access to MFIs or even where MFIs exist some poor people may prefer the informal money lenders.

There are positive features that may make the informal moneylenders more close to the poor people and able to respond to their needs. These features include;

- Simple procedures, clear terms, timely disbursement and loans backed by the borrowers' character rather than group collaterals. Microfinance has actually taken the combination of these positive features of this informal money lending into more formal financial institutions.

1.5.4 Microfinance institutions in Ethiopia

By the year 2020/21 (Gregorian calendar), there are Forty One (41) Microfinance Institutions (MFIs) operational in Ethiopia. They altogether mobilized (approximately) Birr 47 billion in saving deposit. They altogether provided loans to the economically active poor Ethiopians (approximately) equal to Birr 64.6 billion. (National Bank Of Ethiopia, 2020/21)



Activity 1.5

1. What is the difference between micro-financing and micro-crediting?
2. List the reasons for the existence of microfinances?
3. Who are the clients of micro-crediting in your locality?
4. Think of microfinance institutions in your area or in Ethiopia, and
 - a. Summarize activities you think they are doing.



Self-test exercise 1.5

Dear distance learner, please summarize the reasons for the existence of microfinances and summarize the activities they provide in your surroundings. Did you try? Great job!



Suggested Answers

1. Basic reason for the existence of microfinances is that the active poor lack collateral requirement of the formal banks for their loan requirements.
2. Understand #1.
3. Activities of microfinances – they give saving and credit services to the active poor in the town. To do this, they use group lending as a collateral.

You can summarize whatever activity you think microfinances are doing (having some microfinances from their locality in mind).

1.6 Electronic Banking (e-banking)



Overview

The modern banking system is electronic banking or e-banking. It is a very recent technology that makes money market transactions very convenient, very fast and most secure. In this section you will learn about the electronic banking system.



Learning outcomes

By the end of this section, students will be able to.

- Describe the role of technological innovations in the banking service sector,
- Examine how e-banking has increased the convenience of transactions
- Tell the e-banking system they use.

Key Words

E-banking, Mobile banking, ATM cards, Online banking



Start Up Activity

What is mobile banking?

What other e-banking services do you know?

Technology in all sectors of the economy is changing faster than ever and the banking/ financial sector is not an exception. Banking and money management became increasingly more electronic.

Electronic banking, which is also known as electronic fund transfer (EFT), refers to the transfer of funds from one account to another through electronic methods. Mobile phone payment is one good example for this electronic banking. A study in United States of America (USA)

found out that more than twenty (20) percent of mobile phone owners used mobile phone payment methods.

There are three key aspects of electronic banking. automated teller machines (ATMs), direct deposits and debit card purchases.

i. **Automated Teller Machines (ATMs)**

Most people are familiar with automated teller machines (ATMs) as a method for withdrawing money/cash quickly and easily. They give you the flexibility to withdraw cash from your registered bank account (having credit or debit cards) almost any time given there is electric power and internet (network) connection. Automated teller Machines (ATMs) will also let you transfer funds between your accounts or to other accounts, make deposits, bill payments and also exchange currencies. ATMs allow customers to complete basic transactions without the aid of a branch representative or a teller. Service fees are commonly charged for cash withdrawals when using ATMs.

ii. Direct Deposit

Suppose you are a worker and you are paid regularly, then your employer can deposit your salary directly into your bank account, this is known as direct deposit and it is one form of electronic banking system. This method is commonly used to transfer an employee's salary, tax refunds, investment redemptions, payments from retirement accounts, and government benefits like Social Security.

Direct deposit requires the use of an electronic network that allows deposits to take place between banks. This network is called the automated clearing house (ACH). Because the funds are transferred electronically, recipients' accounts are credited automatically.

iii. Debit Card Purchases

Debit card purchases are similar to credit card transactions with some differences. You can make debit card purchases in person, online or over the phone. In debit card purchase, the money is taken directly out of your linked account and you can't spend more than you have.

When using a debit card to make a purchase you are paying for the item then and there, drawing on funds in your bank account. When you use a credit card, however, you're essentially borrowing money from the card company for the item. It pays the merchant, and then bills you for the amount. You repay it when you get your monthly statement. If you don't pay the whole amount, you pay interest on the remaining portion, as you would with any loan.

iv. Mobile Banking

Mobile banking is the act of making financial transactions on a mobile device. Advantages to mobile banking include the ability to bank anywhere and at any time. Disadvantages include security concerns and a limited range of capabilities when compared to banking in person or on a computer.



Activity 1.6

1. How has the e-banking system contributed to the banking service?
2. What e-banking system do you personally use?
3. Compare going to the bank in person for banking services and mobile banking
4. Based on your or your family's experience, summarize the advantages of using mobile banking



Self-test exercise 1.6

Dear distance learner, please summarize the benefits of using mobile banking in relation to going to the bank in person. Did you try? Great job!



Suggested Answers

- o *Mobile banking saves lots of time and energy for doing the financial intermediation of the formal banks (going in person).*

Transferring money to other people, checking money balances on our bank accounts, making payments, etc.

1.7 Indigenous financial institutions



Overview

“iddirs” and “iqubs” are ancient financial inventions in Ethiopia. They are still playing and equal role if not equal with banks and microfinance institutions in fulfilling the financial need of the societies. This section will teach you about the.



Learning outcomes

By the end of this section, students will be able to.

- Distinguish the difference between different types of indigenous financial institutions in Ethiopia,
- Examine the role of indigenous financial institutions on the improvement of the livelihoods of your community

Key Concepts

Indigenous financial institutions; “Iqqub”; “Iddir”; Saving and Credit Cooperatives (SACCs)



Start Up Activity

Tell us anything about any indigenous (local) financial institution in your locality.

Ethiopians have traditional indigenous financial system called 'iqqub' and 'idir/mahiber'. Depending on their income, Ethiopians save some amount of money in "iqqubs" per week. This ranges from 100 birr to 10, 000 birr based on the capability of the members in that "Iqqub". While most employees do this on a monthly basis, business people also save on either a weekly or even daily basis. The Iqub money is used mostly in social occasions such as *weddings, funerals, sickness*, and also to finish some unfinished activities like building a house, etc. and it circulates among members regularly until all the members get their part of the saving. (Lakew & Azadi, 2020).

Iddir on the other hand is mostly for funeral and associated services. Membership is mostly based on locality and the contributions are monthly. It is based on the wisdom that, death to the family member is sure to come one day. Until that, the member will contribute some amount of money every month in "iddirs". The Iddirs will give the member some amount of money so that he will undertake the necessities.

These will be discussed briefly in the following sub-sections.

1. **The "iqqub" - or Saving club**

Membership in the "iqqub" is based on *pre-established social ties*. It consists of *homogeneous groups*. people from the *same work place, same ethnic background, same trade or business activity, schooling background or neighborhood*.

People from all walks of life, ranging from *the rural poor to the urban rich, from shoe-shine boys to high level government officials*, participate in the "iqqub", and the capital contributions vary according to *the purpose of the "iqqub" and the economic status of its members*. (AREDO, 1993)

People prefer "iqqub" to the formal financial sector because of the following reasons as discussed by (AREDO, 1993).

- The strengthening of the ties of solidarity and friendship in the group,
- The forced savings of a contractual nature,
- The flexibility and adaptability of the "iqqub" to various situations and needs,
- The low risk of default,
- The low or practically non-existent costs of administration and transactions,
- The absence of minimum investment threshold,
- Tendency to gamble and the consequent attraction which the lottery holds for them,

2. **The "iddir"**

"Iddir" is an indigenous financial and social institution that almost exists everywhere throughout Ethiopia. "Iddir" provides a wide range of services including financial and material assistance and consolations to a member in the event of difficulties as well as entertainment as the case may be.

The services provided by "iddirs" include *funeral expenses, financial assistance to families of the deceased and, in some cases, coverage of other risks such as medical expenses, losses due to fire or theft, etc.* Almost every "iddir" has its own by-laws specifying the duties and

responsibilities of members, procedures and functions of the officials.

Social ties are very important in “iddirs” also like the case of “iqqub”. A member is required to attend meetings, be present at funeral ceremonies, visit the sick, etc. The by-laws of “iddirs” are observed because of powerful social sanctions and fines of deviant behaviors among members of the “iddirs”.

Members’ contributions vary from one “iddir” to another. Most of the common fund is deposited in the bank account purposely opened for the “iddir” while only a small sum of money is kept with the officials for emergency purposes. Most “iddirs” have their own tents, benches or chairs, utensils, etc. These materials are used mainly in the event of the death of a participant’s family member. (AREDO, 1993).

3. **The Savings and credit co-operatives (SACCs)**

Savings and credit co-operatives (SACCOs) can be designated as semi-formal financial institutions. They are outside the control of the central authorities with respect to ownership of assets and management.

The SACCOs in Ethiopia have recent origins. The oldest ones were established in the late 1960s, and they grew very slowly until 1978. One reason behind such slow growth was the political and social instability which followed the 1974 uprising. SACCOs have been growing fast since 1978. However, the rate of growth is not the same for all co-operatives. Some of them are growing at very fast rates. (AREDO, 1993)

SACCOs are considered to have immense potential in financing short term loans for agricultural production technologies and undertake off-farm income generating activities.. (Tsefamariam, 2015).



Activity 1.7

1. Mention the different types of indigenous financial institutions in Ethiopia
2. Summarize the economic and social benefits of “iqubbs”, “iddirs” and “SACCOs”.



Self-test exercise 1.7

Dear distance learner, please summarize the benefits of “Iqubs”, “Iddirs” and “SACCOs”. Did you try? Great job!



Suggested Answers

1. Benefits of indigenous financial institutions include saving, insurance and credit facilities.

You can list all the benefits you know of the indigenous financial institutions, think of the iqqubs, iddirs and SACCOs you know in your area.

 **Check List**

Dear distance learner, we hope you enjoyed working on this section. Now it is time to check your understanding about evolution of money. Read each question and put a tick (√) mark in the 'yes' or 'no' box, which helps you decide on your level of understanding of the points presented so far.

Objectives	Yes	No
Can you describe Financial Intermediaries		
Can you describe Financial Markets		
Can you describe Financial Institutions		
Do you understand Historical Development of Banks in Ethiopia		
Can you describe Micro-finance institutions		

Dear distance learner, did you mark any box under the 'No' column? If so, please look at the corresponding item to the left and go back to your text and read about it.



Unit Summary

Financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, for instance- Commercial Bank of Ethiopia. Financial intermediaries offer a number of benefits to the average consumer, such as safety, liquidity, and economies of scale involved in banking and asset management.

Financial markets are markets that provide channels for allocation of savings to investment. They provide a variety of assets to savers as well as various forms in which the investors can raise funds and thereby decouple the acts of saving and investment.

Financial institutions are *institutions that serve as financial intermediaries*.

In Ethiopia modern banking started in 1905. with the establishment of *Abyssinian Bank*, based on a fifty-year agreement with the *Anglo-Egyptian National Bank*.

Microfinance institutions (MFIs)- are financial institutions that give access to financial services such as *savings, credit, insurance and money transfer* to people that otherwise would remain un-served by the traditional banking system that asks for collaterals.

Electronic banking, which is also known as electronic fund transfer (EFT), refers to the transfer of funds from one account to another through electronic methods.

People from all walks of life, ranging from *the rural poor to the urban rich, from shoe-shine boys to high level government officials*, participate in the “iqqub”, and the capital contributions vary according to *the purpose of the “iqqub” and the economic status of its members*.

“*Iddir*” is an indigenous financial and social institution that almost exists everywhere throughout Ethiopia. “*Iddir*” provides a wide range of services including financial and material assistance and consolations to a member in the event of difficulties as well as entertainment as the case may be.



Answers to Activities

The following are possible answers to the activities in unit one.

Activity 1.1

1. *Financial intermediaries* are individuals (money lenders) or institutions (banks, microfinance institutions) who lend money to those in need. To get the loan/saving services one should register at the financial institutions and fulfill the lenders/savers criteria.
 - a. This process of saving and lending money is called *financial intermediation*.
2. *Examples* of financial intermediaries include friends/relatives, banks, microfinance institutions, iquubs and iddirs, etc.

Dear student, list the real examples from your locality.

For instance, mention names of banks, names of microfinances, names of iddirs, names of iquubs, etc. that you know from your locality.

Activity 1.2

1. Financial markets are places or situations where financial instruments/assets are traded.
2. Components of financial markets are. Money markets & Capital markets
3. *Examples include.* Money markets- short-term Treasuries (e.g., T-bills), certificates of deposit (CDs), commercial paper, repurchase agreements (repos), and money market mutual funds; Capital Markets- the New York Stock Exchange, American Stock Exchange, London Stock Exchange, and NASDAQ.

Activity 1.3

1. *Definition-* Financial institutions (FIs) are companies engaged in the business of dealing with financial and monetary transactions such as deposits, loans, investments, and currency exchange.
2. *Components of financial institutions/system.* Five Basic Components of Financial System- 1. Financial Institutions, 2. Financial Markets, 3. Financial Instruments (Assets or Securities), 4. Financial Services and 5. Money.
3. *Roles of banks in Society.* Banks operate by borrowing funds-usually by accepting deposits or by borrowing in the money markets. ... Through the process of taking deposits, making loans, and responding to interest rate signals, the banking system helps channel funds from savers to borrowers in an efficient manner.

Definition

T-bills are promissory notes issued with short term maturities (in Ethiopia we have 1-month, three-month, six month and twelve-month maturity periods). They offer investors the lowest yield of all government bond issues. Similar to zero- coupon bonds, T-bills are auctioned off to investors at a discount to par.

Activity 1.4

1. After reading the sections about the historical development of banks, you should write a story of at least one bank.
2. More funds will be available for lending and investment.
3. Major functions of the following banks.
 - a. NBE- over all supervision of the banking sector and money supply.
 - b. CBE- taking deposits and providing loans.
 - c. DBE- provide loan for development projects.

Activity 1.5

1. Basic reason for the existence of microfinances is that the active poor lack collateral requirement of the formal banks for their loan requirements.
2. Let you list whatever they think is reason and make them understand #1.
3. Activities of microfinances – they give saving and credit services to the active poor in the town. To do this, they use group lending as a collateral.
4. Make them discuss whatever activity they think microfinances are doing (having some microfinances from their locality in mind).

Activity 1.6

- Mobile banking saves lots of time and energy for doing the financial intermediation of the formal banks (going in person).
- Transferring money to other people, checking money balances on our bank accounts, making payments, etc.

Activity 1.7

1. Benefits of indigenous financial institutions include saving, insurance and credit facilities.
2. List all the benefits you know of the indigenous financial institutions such as iqqubs, iddirs and SACCOs in your area.



Answer for Review Exercises

I. True/False

1. False
2. True
3. False
4. True
5. False
6. True

ii. Choose the best answer from the given alternatives

1. D
2. C
3. A
4. C

III. Fill in the blank spaces for each of the following with appropriate words

1. Iqubus & Iddirs
2. ATMS, Direct Deposits, Debit/Credit card and Mobile banking
3. Deposits/Loans
4. Monetary and Banking Proclamation No. 83/1994 /1994.

Unit 2

Economic Growth



Unit Introduction

The central concern of economics rests on how best we explain what Adam Smith called the 'wealth of nations. An answer to the question of why some countries are rich and others are poor can only be given by assessing their economic growth. The changes we realize in the types of economic activities undertaken and also the methods used in their performances are best explained by the changes in the level of the economy, i.e., economic growth. The capability that a country has to alleviate poverty and provide its citizens with a reasonable and higher standard of living depends, to a large extent, on how rapidly its economy grows. The majority of modern literature in economics is dedicated to an understanding of the processes of economic growth.

In this unit of grade 10th economics module, you will learn about “*macroeconomic variables, definition and measurement of economic growth, sources of economic growth, economic factors and non-economic factors, why growth varies across economies, classification of countries by income levels. Low income, middle income and upper income, measurement of productivity, the effect of productivity on economic growth, the weaknesses of using GDP/GDP Per Capita, and the business cycle. its definition and phases*”.

Thus, you should be thinking about your country's economic status throughout this unit. You should associate every theoretical discussion with Ethiopia's perspective.



Unit Outcomes

After successfully completing this unit, students will be able to.

- ◆ Mention macroeconomic variables
- ◆ Tell how an economic growth can be measured
- ◆ Identify the major sources of economic growth.
- ◆ Explain the different phases of business cycles.
- ◆ Discuss about alternative ways of measuring economic growth and the weaknesses of using GDP/GDP per capita.

The Required Study Time for this unit is 12 Hours.

Unit Learning Strategies

Dear distance learner, remember each unit has a self-study format. The following learning strategies will help you study this unit.

- Reading the topics

- Doing various activities
- Completing written exercises
- Activities based on the learner's experience
- Extra-curricular learning
- Scenario-based activity
- Auto tutorial instruction

2. 1 Review of Macroeconomic Variables



Overview

A country passes through ups and downs in its production of goods and services. Citizen's living conditions, on the other hand, depends on the production of these goods and services. Macroeconomic variables are those measuring tools of these performances. In this section, discussion will be made on macroeconomic variables such as gross domestic product (GDP), inflation, unemployment and balance of trade, among others.



Learning outcomes

By the end of this section, you will be able to.

- ◆ Identify the basic macroeconomic variables,
- ◆ Evaluate the desirable and the non-desirable magnitudes of these macroeconomic variables

Key Concepts

National Income Accounting (GDP, GNP, etc.), Economic Growth, Economic Development, Inflation, Unemployment



Start Up Activity

What is the difference between macroeconomics and microeconomics?



Scarcity makes the study of Economics a necessity rather than a choice. Economics is a social science that deals with making decisions of getting the best out of the limited resources that we have. If these decisions are made at individual decision makers level, the analysis will be categorized under *microeconomics*. If on the other hand, these decisions are made at a country level, and the analysis will be categorized under *macroeconomics*.

Individual decision-making units in economics include individual consumer (buyer) and individual producer (seller) in the economy. Consumers try to maximize their satisfaction from the goods and services they consume. Producers try to maximize their profit from selling the goods and services. Thus, *microeconomics* gives a good analysis of how much

the consumer should consume (buy) with the available budget. Similarly, the producer decides on the quantity of input used in the production process to maximize profit from the goods and services produced with the limited factors of production available. This is known in economics as optimization.

Nations make decisions through their governments or leaders. The endowments of countries such as land, forest, water, population, machineries, capital, etc. are limited. If not used economically, they will be wasted without attaining the macroeconomic goals of. increased economic growth, reduced unemployment, stable price, increased balance of payment, etc. Thus, *macroeconomics* is the best tool available in making the decision of giving priorities in production and consumption at country level so that we attain the macroeconomic goals mentioned above. These macroeconomic decisions are made through government macroeconomic policies.

The major macroeconomic variables include- *Current Account Balance, Inflation, Economic Growth and Unemployment*. On the other hand, the major macroeconomic goals pursued by governments of countries are; *improved current account balance; stable prices; increased economic growth; and reduced unemployment*.

- i. *Current Account Balance*- countries sell their goods and services to other countries (*export*) and also, they buy goods and services from other countries (*import*). Thus, current account balance is the difference between the dollar value of goods a country exports and the dollar value of goods a country imports.
 - Therefore, *current account or trade balance = Exports (X) – Imports (M)*.

There will be two scenarios.

Scenario 1- If the value of exports (X) is greater than the value of imports (M), there is a trade surplus. This is a desirable outcome. The country is benefitting from the trade. This is true for developed countries exporting expensive manufactured commodities.

Scenario 2- If the value of exports (X) is less than the value of imports (M), there is a trade deficit. This is not a desirable outcome. The country is now losing from the trade. Least developed countries face this scenario since they export cheap primary agricultural commodities.

- ii. *Inflation*- is an increase in the overall price level of goods and services over a certain period of time. The rise in the general level of prices, often expressed as a percentage, indicates that a unit of currency effectively buys less than it did in prior periods. This implies that, when there is inflation, there will be a fall in purchasing power of currencies over time. High inflation is not desirable in an economy. This would mean that policymakers try and keep inflation low.

There are two types (causes) of inflation;

- ⇒ Cost-push inflation. when the costs of production is high producers increase price to be profitable; and
- ⇒ Demand-pull inflation. when growing demand (being able to pay higher

prices) for goods that firms produce, allowing firms to even increase prices to gain more profit.

- iii. *Economic growth*- is the amount that the level of output within an economy increases over a given time period usually a year. Economic growth is extremely desirable since it means that, the people within an economy are getting richer. Economic growth can be increased in a number of ways, such as *technological improvement, an increase in the demand for goods and services, and an increase in the size of the workforce.*
- iv. *Unemployment.* refers to the number of people within an economy who are willing and able to work, but do not have a job at the going wage rate. There are a number of different types of unemployment. *frictional unemployment;* - caused by the search for a new job or a transition between jobs; *structural unemployment;* - caused by the decline of a specific industry, for example type-writing or coal mining; *seasonal unemployment;* - caused by the time of year, drought time for farmers; and *cyclical unemployment;* - caused by a recession – a reduction in the level of output within an economy.



Activity 2.1

1. List down the basic macroeconomic variables
2. What are the sources of economic growth? List them down.
3. Explain why are poor countries are in current account deficit?



Self-test exercise 2.1

Dear distance learner, please summarize sources of economic growth of countries. Why do you think are poor countries in current account deficit? Did you try? Great job!



Suggested Answers

- Sources of economic growth- increase in raw materials (inputs) and technological progress. Besides, good weather conditions (rainfall) are factors for economic growth in developing countries.
- Poor countries export cheap primary agricultural products and import heavy machineries which are very much expensive. Thus, low export – high import = deficit in current account.

2.2 Definition and Measurement of Economic Growth



Overview

In this section you will learn about the gross domestic product (GDP). Higher GDP is an indication of good production performance of country and vice versa. You will also learn the limitations of the GDP and other alternatives available.



Learning outcomes

By the end of this section, you will be able to.

- Define economic growth in different time periods
- Measure economic growth
- Explain the major sources of economic growth in their locality
- Differentiate between economic growth and economic development

Key Concepts

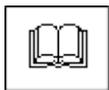
Gross Domestic Product (GDP), Gross Domestic Product per Capita (GDP per capita), Population, Real Gross Domestic Product (RGDP), Real Gross Domestic Product Per Capita



Start Up Activity

What is economic growth?

2.2.1 Definition and measurement of Economic Growth



Economic growth in the **short run** is when RGDP increases in the short run. Increase in RGDP is given by the following formula.

$$g = \frac{RGDP_t - RGDP_{t-1}}{RGDP_{t-1}} \times 100\%$$

Economic growth in the **long run**, is when there is a *sustained increase in per capita income and associated structural changes in the economy*. That means GDP increase for subsequent years and Structural change from agricultural sector to manufacturing sector also takes place. Per capita real GDP, also known as Per Capita Income, is given by the following formula. It is the RGDP of the given year divided by the total population of the year.

$$\text{Per capita RGDP} = \frac{RGDP_t}{\text{Population } t}$$

Structural changes are usually characterized by industrialization; a *fall in the share of agriculture both in GDP and in the workforce, and a corresponding increase in the share of industrial and service sectors*.

Sources of economic growth in an economy

Economic growth comes when *resources are recreated, reorganized and reallocated in a more efficient manner*. Technological improvement brings economic growth since it increases productivity. Imagine using tractors rather than oxen for farming. Tractors can do far more than do the oxen within a short period of time. The others are the factors of production; increases in the factors of production like land, labor and capital bring economic growth.

Economic growth is characterized by supply of more as well as better goods and services

on a sustainable basis with minimum harmful byproducts. Higher growth rate of the GDP (economic growth) is taken as **basic** for improving living standard, alleviating poverty, creating more employment opportunities and greater social security.

The level of real GDP is a good indicator of economic prosperity, and the growth of real GDP is a good indicator of economic progress. (Mankiw, 2012). Growth rate measures how rapidly real GDP per person grew in the typical year.

2.2.2 Economic growth vs Economic development

Economic growth and economic development are taken wrongly as synonyms. Growth refers to the rate of increase in GDP or GDP per capita. Development, on the other hand, refers to a much broader concept that applies to a process of overall transformation in different aspects of human life. It deals with *progressive changes in social, political, institutional and economic structures*. Economic growth can take place without economic development but for economic development to take place economic growth is a necessary but not a sufficient condition. In this context, we can say that growth is a subset of development.

Activity 2.2

1. Define economic growth in the short run and in the long run.
2. Calculate the economic growth of Ethiopia by taking the GDP data of the country.
3. What sources contribute to economic growth in your area?
4. Differentiate between economic growth and economic development.



Self-test exercise 2.2

Dear distance learner please defines economic growth, calculate economic growth and differentiate between economic growth and development. Did you try? Great job!



Suggested Answers

1. Economic growth is when Real Gross Domestic Product (RGDP) increases in the short run, whereas it refers to a sustained increase in per capita income and associated structural changes in the economy, in the long run.
2. According to the data for 2019, 2020 and 2021 (Gregorian Calendars), economic growth of Ethiopia was calculated in the following table. the currency is in USD. This is only for exercise purpose!

2019	Real GDP	95.91 billion	2021	Real GDP	110.00 billion
	Population	110 million		Population	110 million
	GDP per capita	871.91		GDP per capita	1000
	Economic growth	We need 2018 data!		Economic growth	14% ??
2020	Real GDP	96.61 billion			
	Population	110 million			
	GDP per capita	878.27			
	Economic Growth	$878-872= 0.007\% ??$			

Economic growth is an increase in the real gross domestic product per capita (Real GDP per Capita) over time. **Economic development** is economic growth coupled with infrastructural, institutional and other growths for a long period of time. Increase in health facilities and decrease in income inequality are among the indicators of economic development.

2.3 Sources of Economic Growth

Section overview

The amount by which the GDP change is its growth and this measures the economic growth of a country. The higher the change, the faster the country is growing and vice versa. There are different reasons for this variation, and we call these sources of economic growth. They include factors of production like labor, land, capital and technology. In this section, you will learn more about these.

Section learning outcomes

By the end of this section, students will be able to.

- ◆ Explain why some countries are rich and others are poor
- ◆ Discuss how productivity is determined
- ◆ Evaluate the characteristics of economic growth in Ethiopia
- ◆ Mention the criteria of categorizing the world countries into different groups

Key Concepts

Factors of production, Technological progress, Economic growth



Start Up Activity

What do you think are the sources of economic growth in Ethiopia?

In the world, there is tremendous variation in the standard of living. In richer countries' (such as; the United States, Japan, or Germany) average income, is more than ten times the average income of poor countries (such as India, Indonesia, or Nigeria). These large differences in income lead to large differences in the quality of life. People in richer countries have *better nutrition, safer housing, better healthcare, and longer life*

expectancy as well as more automobiles, more telephones, and more televisions.

In different countries, economic growth rates are substantially different. Recently, some East Asian countries, such as Singapore, South Korea, and Taiwan, have achieved economic growth of about seven percent (7%) per year. At this rate, their average income doubles every ten (10) years. Even more recently, China has enjoyed an even higher rate of growth—about twelve percent (12%) per year. *A country experiencing such rapid growth can, in one generation, go from being among the poorest in the world to being among the richest.*

2.3.1 Productivity and living standard differences among countries

Explaining the large variation in living standards around the world is in one sense very easy. As we will see, the explanation can be summarized in a single word—productivity. But in another sense, the international variation is deeply puzzling. To explain why incomes are so much higher in some countries than in others, we must look at the many factors that determine a nation's productivity.

Why productivity is so important. Productivity's key role in determining living standards is as true for nations as it is for stranded sailors (Robinson Crusoe). An economy's gross domestic product (GDP) measures two things at once. *the total income earned by everyone in the economy and the total expenditure on the economy's output of goods and services.* GDP can measure these two things simultaneously because, for the economy as a whole, they must be equal. Put simply, an economy's income is the economy's output.

A nation can enjoy a high standard of living only if it can produce a large quantity of goods and services. Americans live better than Nigerians because American workers are more productive than Nigerian workers. The Japanese have enjoyed more rapid growth in living standards than Argentineans because Japanese workers have experienced more rapid growth in productivity.

How productivity is determined. Crusoe (in Robinson Crusoe) will be better at catching fish (he will be more productive), for instance, *if he has more fishing poles, if he has been trained in the best fishing techniques, if his island has a plentiful fish supply, or if he invents a better fishing lure.* Each of these determinants of Crusoe's productivity—which we can call *physical capital, human capital, natural resources, and technological knowledge*—has a counterpart in more complex and realistic economies. Let's consider each factor in turn.

- i. *Physical capital Per worker-* Workers are more productive *if they have tools with which to work.* Physical capital per worker is the amount of tools and machineries available for each worker to work with.
- ii. *Human Capital Per Worker-* A second determinant of productivity is human capital. Human capital is the economist's term for the knowledge and skills that *workers acquire through education, training, and experience.* Human capital includes the skills accumulated in early childhood programs, grade school, high

school, college, and on-the-job training for adults in the labor force. *Producing human capital requires inputs in the form of teachers, libraries, and student time.*

- iii. *Natural Resources Per worker-* A third determinant of productivity is natural resource. Natural resources are inputs into production that are provided by nature, such as land, rivers, and mineral deposits. Differences in natural resources are responsible for some of the differences in standards of living around the world. The historical success of the *United States* was driven in part by the *large supply of land well suited for agriculture*. Today, some countries in the Middle East, such as *Kuwait and Saudi Arabia*, are rich simply because they happen to be on top of some of the *largest pools of oil in the world*. Although natural resources can be important, *they are not necessary for an economy to be highly productive in producing goods and services*. Japan, for instance, is one of the richest countries in the world, despite having few natural resources. International trade makes Japan's success possible. Japan imports many of the natural resources it needs, such as oil, and exports its manufactured goods to economies rich in natural resources.
- iv. *Technological Knowledge-* A fourth determinant of productivity is technological knowledge—the understanding of the best ways to produce goods and services. A hundred years ago, most Americans worked on farms because farm technology required a high input of labor to feed the entire population. Today, thanks to advances in farming technology, a small fraction of the population can produce enough food to feed the entire country. *This technological change made labor available to produce other goods and services.*

2.3.2 Characteristics of Economic Growth

Simon Kuznets, a renowned Economist and the father of national income accounting, identified five major characteristics of modern economic growth.

- a) *High rates of increase in per capita income.* Modern economic growth essentially means high rates of growth of per capita income over a fairly long period of time.
- b) *High rates of increase in factor productivity.* Modern economic growth also requires increase in the productivity of all the factors of production.
- c) *High rates of structural transformation.* Modern economic growth requires a shift in the economic activities from less productive (agricultural) to more productive (industrial) areas. Growth of the entrepreneurial class, which has the desire and capacity to undertake new economic activities, is an essential prerequisite for structural transformation to take place.
- d) *Increase in the rates of saving and investment.* Economic growth takes place when the domestic saving and investment rates rise. The establishment and expansion of modern financial services is necessary for mobilizing domestic resources.
- e) *Increasing application of modern scientific knowledge in the production process.* Application of scientific knowledge in the production process increases the

efficiency of resource utilization and besides provides substitutes for the resources that are scarce.

2.3.3 Categories of the world countries according to Income

The most striking feature of the global economy is its extreme contrasts. We have developed countries on the one side and underdeveloped countries on the other.

With so much knowledge and with the movement of people, information, and goods and services so rapid and comparatively inexpensive, how have such large gaps managed to persist and even widen? (Todaro & Smith, 2012).

The most common way to define the world countries is by their per capita income as developed and developing. Several international agencies, including the Organization for Economic Cooperation and Development (OECD) and the United Nations, offer classifications of countries by their economic status measured by their per capita income into the above two groups. developed and developing.

In the World Bank's classification system, 210 economies with a population of at least 30,000 are ranked by their levels of gross national income (GNI) per capita. These economies are then classified as;

1. low-income countries (LICs)- *defined as having a per capita gross national income in 2008 of \$975 or less,*
2. lower middle- income countries (LMCs)- *have incomes between \$976 and \$3,855,*
3. upper-middle-income countries (UMCs)- *have incomes between \$3,856 and \$11,906,*
4. high-income OECD countries, and other high-income countries- *have incomes of \$11,907 or more.*

(Often, LMCs and UMCs are informally grouped as the middle-income countries.)

The United Nations, as of 2010, categorize a group of countries with *low income, low human capital, and high economic vulnerability* as the Least Developed Countries (LDCs). This classification includes 49 countries of the world; 33 in Africa, 15 in Asia, plus Haiti.

Activity 2.3

1. Why are some countries poor and others rich?
2. List the factors that make our country's living standard different from the neighboring Kenya.
3. State the nature of economic growth in Ethiopia
4. Identify the various ways of categorizing the world countries.



Self-test exercise 2.3

Dear distance learner please summarize factors that make Ethiopian economy different from that of Kenya; also identify different ways of categorizing countries of the world. Did you try? Great job!



Suggested Answers

1. Our country has large number of population and good natural resources (land, forestry, livestock, water, fish, etc.). But we have poor technology and poor institutional set up leading to poor infrastructure and high corruption. That is why our country has different (low) living standard than the neighboring country (Kenya).
2. Various ways of categorizing the world countries- 1. Level of income. Low-, Middle-, and high-income countries; 2. Level of development. Developed and least developed; etc

2.4. The Weaknesses of Using GDP/GDP Per Capita



Overview

GDP measures the market value of final goods and services of a country. Products and services which are produced and consumed with out market transactions will not be included. Such and other limitations of GDP are the concerns of this section.



Learning outcomes

By the end of this section, students will be able to;

- ◆ Calculate and evaluate the economic growth of Ethiopia for the past five years
- ◆ Identify the weaknesses of GDP per capita based Economics growth calculation.

Key Concepts

Underground economy; Unpaid contributions



Start Up Activity

Recall the definition of the Gross Domestic product (GDP) measurement from your grade 9th economics course.



GDP measures both the economy's total income and the economy's total expenditure on goods and services. Thus, GDP per person tells us the income and expenditure of the average person in the economy. Because most people would prefer to receive higher income and enjoy higher expenditure, GDP per person seems a natural measure of the economic well-being of the average individual. But the following are the limitations of GDP as a measure of economic performance of a nation;

GDP, however, is not a perfect measure of well-being. Some things that contribute to a good life are left out of GDP. One is *leisure*. Suppose, for instance, that everyone in the economy suddenly started working every day of the week, rather than enjoying leisure on weekends. More goods and services would be produced, and GDP would rise. Yet despite the increase in GDP, we should not conclude that everyone would be better off. *The loss from reduced leisure would offset the gain from producing and consuming a greater quantity of goods and services.*

Because GDP uses market prices to value goods and services, **it excludes the value of almost all activity that takes place outside markets.** In particular, *GDP omits the value of goods and services produced at home.* When a chef prepares a delicious meal and sells it at his restaurant, the value of that meal is part of GDP. But if the chef prepares the same meal for his family, the value he has added to the raw ingredients is left out of GDP. Similarly, *child care provided in day-care centers is part of GDP, whereas child care by parents at home is not.* Volunteer work also contributes to the well-being of those in society, but GDP does not reflect these contributions.

Another thing that GDP excludes is *the quality of the environment.* Imagine that the government eliminated all environmental regulations. Firms could then produce goods and services without considering the pollution they create, and GDP might rise. Yet well-being would most likely fall. The deterioration in the quality of air and water would more than offset the gains from greater production.

GDP also says nothing about *the distribution of income.* A society in which 100 people have annual incomes of \$50,000 has GDP of \$5 million and, not surprisingly, GDP per person of \$50,000. So does a society in which 10 people earn \$500,000 and 90 suffer with nothing at all. Few people would look at those two situations and call them equivalent. GDP per person tells us what happens to the average person, but behind the average lies a large variety of personal experiences. (Mankiw, 2012).

GDP also excludes those transactions that take place in Black markets. Their transactions are valuable to the society's well-being but since they are illegal, they will not be counted in the GDP.

- In the end, we can conclude that GDP is a good measure of economic wellbeing for most—but not all—purposes. It is important to keep in mind what GDP includes and what it leaves out.

Activity 2.4

1. Describe the economic growth of Ethiopia over the past five years.
2. GDP per capita overestimates the individual's annual incomes. True/False. Explain.



Self-test exercise 2.4

Dear distance learner, please describe the economic growth of Ethiopia over the past five years. Is it true that GDP Per capita over estimates citizen's annual income Did you try? Great job!



Suggested Answers

1. Ethiopia's economy experienced strong, broad-based growth averaging 9.4% a year from 2014/15 to 2019/20, Ethiopia's real gross domestic product (GDP) growth slowed down to 6.1% in 2019/20 due to COVID-19 (coronavirus pandemic). Industry, mainly construction, and services accounted for most of the growth. Agriculture was not affected by the COVID-19 pandemic and its contribution to growth slightly improved in 2019/20 compared to the previous year. Private consumption and public investment explain demand-side growth, the latter assuming an increasingly important role.
2. True. Per capita GDP divides RGDP by Total population, implying that all income of the country is divided by all the population resulting in over estimation.

2.5. The Business Cycle and Its Phases



Overview

Business cycle measures the ups and downs in the production of goods and services, it is a cycle as the name implies. You will learn more about it in this section.



Learning outcomes

By the end of this section, you will be able to;

- ◆ Describe the business cycle
- ◆ Explain the ups and downs in the business cycle



Start Up Activity

What is a "business cycle"?

Key Concepts

Business cycle; Boom; Recession; Depression; Recovery

The Business Cycle and its Phases

The term business cycle is somewhat misleading because it suggests that economic fluctuations follow a regular, predictable pattern. In fact, *economic fluctuations are not at all regular, and they are almost impossible to predict with much accuracy.*

Thus, Business cycle is the irregular and largely unpredictable fluctuations in economic activity, as measured by the production of goods and services or the number of people employed. (Mankiw, 2012).

Phases of the business cycle- Changes in aggregate demand bring about changes in the level of output, employment, income and price. These changes are generally cyclical in nature and follow a cycle of four different phases.

1. Prosperity or boom;
2. Recession;

3. Depression or slump; and
4. Recovery.

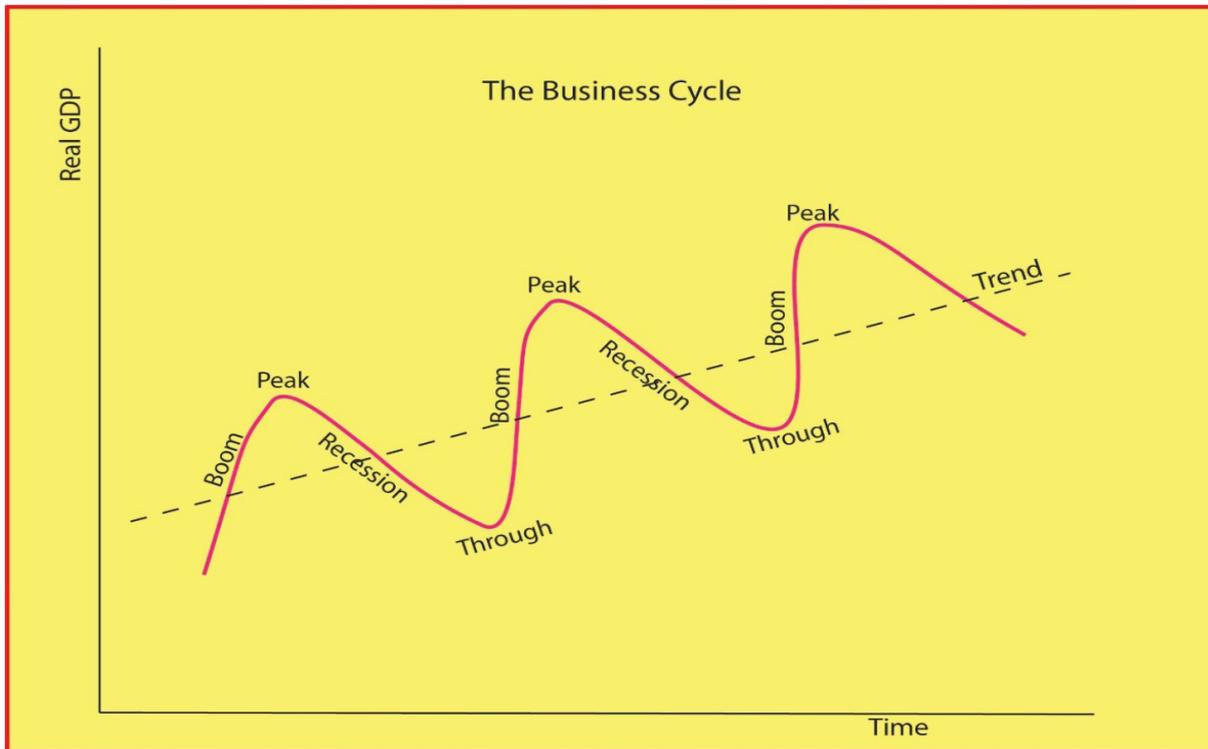


Figure 2.1. The Business Cycle

Source- Sketched by the author

- i. **Prosperity or boom or peak-** is a phase of economic activity characterized by rising demand, rising prices, rising investment, rising employment, rising incomes, rising purchasing power and hence rising demand and so on. The investors, therefore, voluntarily undertake risks and go in for investment. These further fuels boom conditions through the working of the multiplier effect.
- ii. **Recession-** during the boom period, the economy may get over- heated and the monetary authorities, the financial institutions and the business itself may begin to play cautious. There may be cuts in investment, resulting in cuts in employment, fall in incomes, decline in purchasing power and demand. Prices may begin to fall.
- iii. **Depression or slump or trough-** if the effective corrective measures cannot be undertaken, the economy may find itself go into depression. It is a stage when the business confidence is at its lowest. Investment, employment, output, income and prices touch the bottom.
- iv. **Recovery or expansion-** as the economy moves out of depression, it enters the phase of recovery. Sustained recovery will find the level of investment, employment, output, income and prices moving upwards. This may finally result in boom conditions in the economy.



Activity 2.5

1. What is the Trend Line in the business cycle diagram?
2. Which line shows the growth in real GDP



Self-test exercise 2.5

Dear distance learner, please differentiate between trend line and actual GDP in the business cycle. Did you try? Great job!



Suggested Answers

1. The trend line in business cycle diagram is the full employment level of production.
2. Real GDP growth is indicated by the actual line (cycle) fluctuating around the Trend Line.



Check List

Dear distance learner, we hope you enjoyed working on this section. Now it is time to check your understanding about evolution of money. Read each question and put a tick (✓) mark in the 'yes' or 'no' box, which helps you decide on your level of understanding of the points presented so far.

Objectives	Yes	No
Can you list and describe Macroeconomic Variables		
Can you Define and describe Measurement of Economic Growth		
Can you list sources of Economic Growth		
Can you explain the Weaknesses of Using GDP/GDP Per Capita		
Can you describe the Business Cycle and graphically show Its Phases		

Dear distance learner, did you mark any box under the 'No' column? If so, please look at the corresponding item to the left and go back to your text and read about it.



Unit Summary

The major macroeconomic variables include. Current Account Balance, Inflation, Economic Growth and Unemployment. On the other hand, the major macroeconomic goals pursued by governments of countries are; improved current account balance; stable prices; increased economic growth; and reduced unemployment.

Economic growth is when Real Gross Domestic Product (RGDP) increases in the short run, whereas it refers to a sustained increase in per capita income and associated structural changes in the economy, in the long run.

Economic growth comes when resources are recreated, reorganized and reallocated in a more efficient manner. Technological improvement brings economic growth since it increases productivity of factors of production.

The United Nations, as of 2010, categorize a group of countries with low income, low human capital, and high economic vulnerability as the Least Developed Countries (LDCs). This classification includes 49 countries of the world; 33 in Africa, 15 in Asia, plus Haiti.

GDP is not a perfect measure of well-being because it excludes. the well-being that one gets from leisure; it excludes the value of almost all activity that takes place outside markets; it also excludes the quality of the environment/or its deterioration; it also excludes issues about the distribution of income; it also excludes Black market transactions.

The term business cycle is somewhat misleading because it suggests that economic fluctuations follow a regular, predictable pattern. In fact, economic fluctuations are not at all regular, and they are almost impossible to predict with much accuracy.



Unit Review Exercises

i. Write True if the statements is correct or False otherwise for each of the following questions

1. Utility is a macroeconomic variable.
2. Increasing personal utility is one of the goals of governments.
3. Economic growth is calculated by the formula "RGDP this year minus RGDP last year divided by RGDP last year times 100%"
4. The requirements for the long run economic growth are Continued Increase in RGDP for many years accompanied by Population growth for many years

1. Multiple Choice Questions. Choose the best answer from the given alternatives for each question

1. Sources of economic growth include _____.
A . Increase in land
B . increase in Labor force
C . increase in pollution
D . A & B
2. The economic growth difference between rich countries and poor countries is because of _____.
A . productivity differences
B . resource differences
C . weather differences
D . blessing differences
3. The business cycle is _____.
A . a regular fluctuation in the actual RGDP of the country around the potential RGDP
B . a sudden change in the actual RGDP of the country
C . an up-ward sloping actual RGDP curve
D . a downward sloping RGDP curve
4. Ethiopia is one of the _____ countries of the world
A . Developed
B . developing
C . rich
D . industrialized

II. Fill in the blank spaces with appropriate words for the following questions

5. RGDP of a country is a _____ value of all _____ goods and services produced _____ in the _____ year calculated at _____ price
6. Current account deficit is when _____ exceeds _____ of a country.
7. There are _____ number of poor countries the world; out of which _____ is in Africa, _____ is in Asia plus _____ according to the 2010 UN classifications of the low income countries.
8. A business cycle reaches its _____ during recession and _____ during expansion.



Answers to Activities

The following are possible answers to the activities in unit Two.

Activity 2.1

- Sources of economic growth- increase in raw materials (inputs) and technological progress. Besides, good weather conditions (rainfall) are factors for economic growth in developing countries.
- Poor countries export cheap primary agricultural products and import heavy machineries which are very much expensive. Thus, low export – high import = deficit in current account.

Activity 2.2

1. Economic growth is when Real Gross Domestic Product (RGDP) increases in the short run, whereas it refers to a sustained increase in per capita income and associated structural changes in the economy, in the long run.
2. According to the data for 2019, 2020 and 2021 (Gregorian Calendars), economic growth of Ethiopia was calculated in the following table. the currency is in USD. This is only for exercise purpose!

2019	Real GDP	95.91 billion	2021	Real GDP	110.00 billion
	Population	110 million		Population	110 million
	GDP per capita	871.91		GDP per capita	1000
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2020	Real GDP	96.61 billion			
	Population	110 million			
	GDP per capita	878.27			
	Economic Growth	$878-872= 0.007\% ??$			

3. **Economic growth** is an increase in the real gross domestic product per capita (Real GDP per Capita) over time. **Economic development** is economic growth coupled with infrastructural, institutional and other growths for a long period of time. Increase in health facilities and decrease in income inequality are among the indicators of economic development.

Activity 2.3

1. Done in previous activity! #1
2. Our country has large number of population and good natural resources (land, forestry, livestock, water, fish, etc.). But we have poor technology and poor institutional set up leading to poor infrastructure and high corruption. That is why our

country has different (low) living standard than the neighboring country (Kenya).

3. Various ways of categorizing the world countries- 1. Level of income. Low-, Middle-, and high-income countries; 2. Level of development. Developed and least developed; etc.

Activity 2.4

1. Ethiopia's economy experienced strong, broad-based growth averaging 9.4% a year from 2010/11 to 2019/20, Ethiopia's real gross domestic product (GDP) growth slowed down to 6.1% in 2019/20 due to COVID-19 (coronavirus pandemic). Industry, mainly construction, and services accounted for most of the growth. Agriculture was not affected by the COVID-19 pandemic and its contribution to growth slightly improved in 2019/20 compared to the previous year. Private consumption and public investment explain demand-side growth, the latter assuming an increasingly important role.
2. True. Per capita GDP divides RGDP by Total population, implying that all income of the country is divided by all the population resulting in over estimation.

Activity 2.5

1. The trend line in business cycle diagram is the full employment level of production.
2. Real GDP growth is indicated by the actual line (cycle) fluctuating around the Trend Line.



Answer for Review Exercises

I. True/False

1. False
2. False
3. True
4. False

Multiple Choice Questions

1. D
2. A
3. A
4. B

II. Fill in the blank spaces with appropriate words for the following questions

1. market/final/in the country/current/base
2. Import value/export value
3. 49/33/15/Haiti
4. Trough/peak

Unit 3

The Ethiopian Economy



Unit Introduction

For about 100 years, the Ethiopian economy experienced changes from market-oriented to centrally planned and back again to a market-oriented economy. From the Monarchy up to 1974, the economy was primarily agricultural. The economy was based on a feudal system under which land ownership was highly inequitable with major portions of farmland being in the hands of wealthy landlords and the very few industries that existed were owned by foreigners.

During the Military Regime (1974 – 1991), the economy shifted to a command economy where socialist principles and ideologies ruled. Substantial land reforms were introduced in the agricultural, industrial and financial sectors. The government owned all the large-scale manufacturing industries, banks and insurance companies. In spite of all these measures, the regime failed to solve Ethiopia's multifaceted problems. That ended when on May 28th, 1991, the EPRDF marched into Addis Ababa and seized power.

After the EPRDF assumed power in 1991, the government followed a market-oriented economy. It supported economic reform based on privatization of state enterprises, promotion of agricultural exports and deregulation through a move towards free market of the economy. The move facilitated significant sectoral growth performances.

With this in mind, this unit the following points will be discussed, “Components of Macroeconomy (GDP); Overview of the main sectors of Ethiopian economy. The Agriculture sector, Role of the agricultural sector, Structure of the Agricultural Sector; Industry. The role of the industrial sector; Service. The role of the service sector, Components of the service sector; Agriculture versus industrial development, Arguments of industrial sector verses the rest of the economic sectors”.



Unit Outcomes

By the end of this unit, students will be able to;

- ◆ Mention the difference between Real GDP and Nominal GDP.
- ◆ Examine the macroeconomic performance of Ethiopia.
- ◆ Analyze the role and performance of different sectors in economic growth.
- ◆ Write a brief report on Ethiopian Economy
- ◆ Compute GDP, NGDP, RGDP and GDP deflator

The Required Study Time for this unit is 13 Hours.

Unit Learning Strategies

Dear distance learner, remember each unit has a self-study format. The following learning strategies will help you study this unit.

- Reading the topics
- Doing various activities
- Completing written exercises
- Activities based on the learner's experience
- Extra-curricular learning
- Scenario-based activity
- Auto tutorial instruction

3. 1. Components of the Gross Domestic Product (GDP)



Overview

GDP as a measure of the production performance of a country is a summation of different components constituting it. In this section you will learn what these components are.



Learning outcomes

By the end of this section, you will be able to;

- Describe the major components of the macro economy (GDP).
- Mention the common consumption expenditures by your family
- Calculate net exports

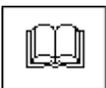
Key Concepts

Consumption (C) ; Investment (I); Gross Domestic Product (GDP); Export (E); Import (M) ; Government Purchases (G)



Start Up Activity

What are the major Components of The Gross Domestic Product (GDP)?



Spending in the economy takes many forms. At any moment, the Soressa family may be having lunch at *Kaku Mame Restaurant*; *Haile Motors* may be building a car factory; the Ethiopian National Defense Force may be procuring Drones; and Ethiopian Airlines may be buying an airplane from Boeing. GDP includes all of these various forms of spending on domestically produced goods and services.

To understand how the economy is using its scarce resources, economists study the composition of GDP among various types of spending. To do this, GDP (which we denote as Y) is divided into four components. consumption (C), investment (I), government purchases (G), and net exports (NX).

$$Y = C + I + G + NX.$$

This equation is an identity—an equation that must be true because of how the variables in the equation are defined. In this case, because each birr of expenditure included in GDP is placed into one of the four components of GDP, the total of the four components must be equal to GDP. Let's look at each of these four components more closely.

Table 3.1 GDP and its components- Numerical Example

Component	Total (Bill of \$)	Per Person (in \$)	Per cent of Total
Gross Domestic Product, Y	\$14, 259	\$46, 372	100%
Consumption, C	10, 093	32,823	71
Investment, I	1,623	5,278	11
Government Purchases, G	2,933	9,540	21
Net Exports, NX	-390	-1, 269	-3

Source. (Mankiw, 2012). 203.

i. Consumption

Consumption is spending by households on goods and services, *with the exception of purchases of new housing*. **Goods**- include household spending on *durable goods, such as automobiles and appliances, and nondurable goods, such as food and clothing*. **Services**- include such intangible items as *haircuts and medical care*. Household spending on *education* is also included in consumption of services (although one might argue that it would fit better in the next component).

ii. Investment

Investment is the purchase of goods that *will be used in the future to produce more goods and services*. It is the sum of purchases of *capital equipment, inventories, and structures*. Investment in *structures* includes expenditure on *new housing*. By convention, the purchase of a new house is the one form of household spending categorized as investment rather than consumption.

The treatment of inventory accumulation is noteworthy. When Dell produces a computer and adds it to its inventory instead of selling it, Dell is assumed to have “purchased” the computer for itself. That is, the national income accountants treat the computer as part of Dell’s investment spending. (If Dell later sells the computer out of inventory, Dell’s inventory investment will then be negative, offsetting the positive expenditure of the buyer.) Inventories are treated this way because one aim of GDP is to measure the value of the economy’s production, and goods added to inventory are part of that period’s production.

Notice that GDP accounting uses the word investment differently from how you might hear the term in everyday conversation. When you hear the word investment, you might think of financial investments, such as *stocks, bonds, and mutual funds*. By contrast, because GDP measures expenditure on goods and services, here the word investment means purchases of goods (such as *capital equipment, structures, and inventories*) used to produce other goods.

iii. Government Purchases

Government purchases include spending on goods and services by *local, state,*

and federal governments. It includes the salaries of government workers as well as expenditures on public works.

The meaning of government purchases requires a bit of clarification. When the government pays the salary of an Army general or a schoolteacher, that salary is part of government purchases. But when the government pays a *Social Security benefit* to a person who is elderly or an *unemployment insurance benefit* to a worker who was recently laid off, the story is very different. These are called *transfer payments* because they are not made in exchange for a currently produced good or service. Transfer payments alter household income, but they do not reflect the economy's production. (From a macroeconomic standpoint, transfer payments are like negative taxes.) Because GDP is intended to measure income from, and expenditure on, the production of goods and services, *transfer payments are not counted as part of government purchases.*

iv. **Net Exports**

Net exports equal the value of foreign purchases of domestically produced goods (value of **exports**) minus the value of domestic purchases of foreign goods (value of *imports*). A domestic firm's sale to a buyer in another country, such as Haile Motors's sale of a car to Kenyans, increases net exports.

The net in net exports refers to the fact that value of *imports is subtracted from the value of exports*. This subtraction is made because other components of GDP include imports of goods and services. For example, suppose that a household buys a Birr 300,000 car from Toyota, the Japanese carmaker. That transaction increases consumption by Birr 300,000 because car purchases are part of consumer spending. It also reduces net exports by Birr 300,000 because the car is an import. In other words, net exports include goods and services produced abroad (with a minus sign) because these goods and services are included in consumption, investment, and government purchases (with a plus sign). Thus, when a domestic household, firm, or government buys a good or service from abroad, the purchase reduces net exports, but because it also raises consumption, investment, or government purchases, it does not affect GDP.

$$\text{Net Exports} = \text{Total Export (E)} - \text{Total Import (M)}$$

Activity 3.1

1. List expenditures from your locality that are included under;
 - Consumption (C)
 - Investment (I)
 - Government Purchase (G)
 - Net Exports (NX)
 - Exports
 - Imports
2. Say Ethiopia sold its exports for 29 million dollars and paid for imports 35 million dollars, what is the net exports for Ethiopia in this case?



Self-test exercise 3.1

Dear distance learner please summarize the different components of GDP from your locality or country. Did you try? Great job!



Suggested Answers

1. Consumption (C) includes all the household expenditures except expenditure on building a house. Expenditure on foods, clothing, schooling, etc. make them list as much as they can!! Investment (I) includes firms' expenditure on their production of goods and services; payment for workers, rents, warehouse, etc. Government Expenditure (G) includes all the payments by the government (federal as well as regional) on their day-to-day activities. Exports (X) include all the goods and services sold outside while Imports (M) includes all the goods and services purchased from outside.
2. Net exports = Exports – Imports
 $29 - 35 = -6$ million us dollars

3.2 Real GDP Vs Nominal GDP

Section overview

The fact that GDP is a price times quantity variable makes it subject to the change in prices of the goods and services. When prices change, while the quantity of goods and services remaining the same, the GDP indicates a false rise in the production capacity of that country. That is why differentiating between real and nominal GDP is required. You will learn more about this in this section.

Section learning outcomes

By the end of this section, students will be able to;

- ◆ Differentiate between Nominal GDP and Real GDP
- ◆ Calculate the GDP deflator

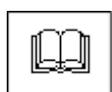
Key Concepts

Real GDP; Nominal GDP; GDP Deflator



Start Up Activity

What comes to your mind when you hear Real GDP and Nominal GDP?



GDP measures the *total spending* on goods and services *in all markets in the economy*. If total spending rises from one year to the next, at least one of two things must be true. Either,

1. *The economy is producing a larger output of goods and services, or*
2. *Goods and services are being sold at higher prices.*

When studying changes in the economy over time, economists want to separate *these two effects*. In particular, they want a measure of the *total quantity of goods and services* the economy is producing *that is not affected by changes in the prices of those goods and services*.

To do this, economists use a measure called **real GDP**. Real GDP answers a hypothetical question. *What would be the value of the goods and services produced this year if we valued these goods and services **at the prices that prevailed in some specific year in the past?***

- By evaluating current production using prices that are fixed at past levels, real GDP shows how the economy's overall production of goods and services changes over time.

To obtain a measure of the amount produced *that is not affected by changes in prices*, we use real GDP, which is *the production of goods and services valued at constant prices*. We calculate real GDP by;

- 1 First designating one year as a base year
- 2 Then use the prices of goods and services in the base year to compute the value of goods and services **in all the years**.

In other words, the prices in the base year provide the basis for comparing quantities in different years.

Suppose that we choose 2010 to be the base year in our example. We can then use the prices of *Kitfo and Chumbo* in 2010 to compute the value of goods and services produced in 2010, 2011, and 2012. Table 2 shows these calculations. To compute real GDP for 2010, we use the prices of *Kitfo and Chumbo* in 2010 (the base year) and the quantities of *Kitfo and Chumbo* produced in 2010. (Thus, for the base year, real GDP always equals nominal GDP.) To compute real GDP for 2011, we use the prices of *Kitfo and Chumbo* in 2010 (the base year) and the quantities of *Kitfo and Chumbo* produced in 2011. Similarly, to compute real GDP for 2012, we use the prices in 2010 and the quantities in 2012. When we find that real GDP has risen from Birr 200 in 2010 to Birr 350 in 2011 and then to Birr 500 in 2012, we know that the increase is attributable to an increase in the quantities produced because the prices are being held fixed at base-year levels.

To sum up. Nominal GDP uses current prices to place a value on the economy's production of goods and services. Real GDP uses constant base-year prices to place a value on the economy's production of goods and services. Because real GDP is not affected by changes in prices, changes in real GDP reflect only changes in the amounts being produced. Thus, real GDP is a measure of the economy's production of goods and services. (Mankiw, 2012).

Our goal in computing GDP is *to gauge how well the overall economy is performing*. Because real GDP measures the economy's production of goods and services, it reflects

the economy's ability to satisfy people's needs and desires. Thus, real GDP is a better gauge of economic well-being than is nominal GDP. When economists talk about the economy's GDP, they usually mean real GDP rather than nominal GDP. And when they talk about growth in the economy, they measure that growth as the percentage change in real GDP from one period to another.

3.2.1 The GDP Deflator

Nominal GDP reflects both the quantities of goods and services the economy is producing and the prices of those goods and services. By contrast, by holding prices constant at base-year levels, real GDP reflects only the quantities produced. From these two statistics, we can compute a third, called the GDP deflator, which reflects only the prices of goods and services.

The GDP deflator is calculated as follows.

$$\text{GDP Deflator} = \frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$$

Because nominal GDP and real GDP must be the same in the base year, the GDP deflator for the base year always equals 100. The GDP deflator for subsequent years measures the change in nominal GDP from the base year that cannot be attributable to a change in real GDP.

The GDP deflator measures the current level of prices relative to the level of prices in the base year. To see why this is true, consider a couple of simple examples. First, imagine that the quantities produced in the economy rise over time but prices remain the same. In this case, both nominal and real GDP rise together, so the GDP deflator is constant. Now suppose, instead, that prices rise over time but the quantities produced stay the same. In this second case, nominal GDP rises but real GDP remains the same, so the GDP deflator rises as well. Notice that, in both cases, the GDP deflator reflects what's happening to prices, not quantities.

Let's now return to our numerical example in Table 7. 2. The GDP deflator is computed at the bottom of the table. For year 2010, nominal GDP is Birr 200, and real GDP is Birr 200, so the GDP deflator is 100. (The deflator is always 100 in the base year.) For the year 2011, nominal GDP is Birr 600, and real GDP is Birr 350, so the GDP deflator is 171.

Economists use the term *inflation* to describe a situation in which the economy's overall price level is rising. The inflation rate is the percentage change in some measure of the price level from one period to the next. Using the GDP deflator, the inflation rate between two consecutive years is computed as follows.

$$\text{GDP Deflator} = \frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$$

Because the GDP deflator rose in year 2011 from 100 to 171, the inflation rate is $100 \times (171 - 100)/100$, or 71 percent. In 2012, the GDP deflator rose to 240 from 171 the previous

year, so the inflation rate is $100 \times (240 - 171)/171$, or 40 percent.

The GDP deflator is one measure that economists use to monitor the average level of prices in the economy and thus the rate of inflation. The GDP deflator gets its name because it can be used to take inflation out of nominal GDP—that is, to “deflate” nominal GDP for the rise that is due to increases in prices. We examine another measure of the economy’s price level, called the consumer price index, in the next chapter, where we also describe the differences between the two measures.

Table 3.2 Real and Nominal GDP- Example

Prices and Quantities				
Year	Price of Kitfo	Quantity of Kitfo	Price of Chumbo	Quantity of Chumbo
2010	Birr 150	100	Birr 250	50
2011	180	150	350	100
2012	200	200	400	150

Given the above hypothetical data, calculate the nominal and real GDP;

Calculating Nominal GDP			
2010	$150 \times 100 = 15,000$	$250 \times 50 = 12,500$	27,500
2011	$180 \times 150 = 27,000$	$350 \times 100 = 35,000$	62,000
2012	$200 \times 200 = 40,000$	$400 \times 150 = 60,000$	100,000
Calculating Real GDP (base year 2010)			
2010	$150 \times 100 = 15,000$	$250 \times 50 = 12,500$	27,500
2011	$150 \times 150 = 22,500$	$250 \times 100 = 25,000$	47,500
2012	$150 \times 200 = 30,000$	$250 \times 150 = 37,500$	67,500
Calculating the GDP Deflator			
2010	$(27,500/27,500) \times 100 = 100$		GDP Deflator= (NGDP/RGDP) *100
2011	$(62,000/47,500) \times 100 = 131$		
2012	$(100,000/67,500) \times 100 = 148$		

Source. Customized from (Mankiw, 2012). 204.



Activity 3.2

Taking three consecutive years (2013, 2014 & 2015), and taking two hypothetical commodities;

1. Calculate Nominal GDP
2. Calculate Real GDP
3. Calculate the GDP deflator



Self-test exercise 3.2

Dear distance learner, please calculate NOMINAL GDP and REAL GDP based on the given information. Did you try? Great job!



Suggested Answers

Given,

Prices and Quantities				
Year	Price 'commodity 1' in Birr	Quantity 'commodity 1' in Units	Price of 'Commodity 2' in Birr	Quantity of 'Commodity 2' in Units
2013	150	150	250	100
2014	150	200	300	150
2015	150	250	350	200
The following are the Nominal GDP, the Real GDP and the GDP deflator calculations;				
(1) Nominal GDP = $\sum Q_i P_i$				
2013	22500		25000	47500
2014	30000		45000	75000
2015	37500		70000	107500
(2) Real GDP (base year 2013) = $\sum Q_i P_{base\ year}$				
2013	22500		25000	47500
2014	30000		37000	67000
2015	37000		50000	87000
(3) GDP Deflator (%) = $\frac{NGDP}{RGDP} \times 100$				
			2013	100
			2014	111.9
			2015	123.5

3.3 The Agricultural Sector in the Ethiopian Economy



Overview

Agriculture is backbone of the Ethiopian economy. It contributes the lion share of export and employment. In this section you will learn more about the contribution of this sector to the economy of the country.



Learning outcomes

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

- ◆ Describe the main sectors of the Ethiopian Economy
- ◆ Examine the forward and backward linkages of the agricultural sector;
- ◆ Assess the role of the agricultural sector in Gross Domestic Product and in the creation of employment.
- ◆ Analyze the structure of the agricultural sector of Ethiopia,

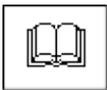
Key Concepts

Agricultural sector; Forward linkage; Compulsory delivery; Backward Linkage ; Household size; Small holder farmer; Price incentive



Start Up Activity

What comes to your mind when you hear agricultural sector in Ethiopia?



According to NBE, 2019/20 annual report data, agriculture's share in GDP has decreased from 40% to 33%, Industry's share in GDP has increased from 21% to 29% and service sector's share in GDP has almost been 40% over the six years from 2014/15 to 2019/20.

For decades, agriculture has been the backbone of the Ethiopian economy. Hence its performance determines the economic well-being of the people. Also, many other economic activities, including transportation and manufacturing, rely heavily on the agricultural sector.

Main Features of the Agricultural Sector- Agriculture contributes about 45% of the overall GDP of the country; generates more than 80% of export earnings; employs about 85% of the population; and supplies about 70% of raw materials to the secondary activities (Central Statistics Office, 2006). The agricultural sector produces both crops and livestock. The crops produced include food crops, cash crops, fruits, and vegetables. It constitutes the greatest share of the country's GDP and export earnings when compared to the livestock production. (Belayneh, Weldeselassie, Legesse, Tasew, Denu, & Bansal, 2011).

Major Problems of the Sector

- Frequent drought,
- Soil degradation largely caused by overgrazing and overpopulation,
- Land fragmentation,
- Prevalence of backward agricultural practices,
- Poor marketing facilities due to poor road networks, etc.
- Rapidly increasing prices of agricultural inputs like fertilizers etc.

Roles of the Agricultural Sector

It is apparent that agriculture is the backbone of the Ethiopian economy, as you can see from the important roles it plays, as discussed in the following sections.

i. It is a source of food and raw materials

One of the main roles of agriculture in the Ethiopian economy is being the source of food and raw materials. For example, agriculture supplies the country with food grains, dairy and meat products. A productive agricultural sector provides relatively abundant food and raw materials to the population.

Backward linkages- an efficient/productive agricultural sector supplies food and raw material to the industrial sector and its labor force. In turn, it has to be supplied with modern inputs and technologies to cope with responding to the growing demand of the non-farming and farming population. Without such support, the agriculture sector appears weak and non-supportive. It may even risk its own population facing food insecurity.

Furthermore, productivity in the agricultural sector improves the level of income received by rural people. Increased income of rural people is believed to generate increased demand for manufactured goods from the industrial sector.

Forward linkages- productivity in the agricultural sector can promote the following forward linkages. First, it reduces the cost of living in the industry- based/urban areas which, in turn, reduces the pressure on wages and makes industrial profit higher. Second, increasing the provision of raw materials reduces the cost of raw materials and makes industrial profits higher. These two factors can contribute significantly to increasing industrial savings and investment that leads to the promotion of the sector.

ii. **It is a source of capital**

Although the agricultural sector provides meager surpluses of savings and taxes to support investment, the transference of surplus from the agricultural sector to other sectors is made through the following three modalities.

- tax;
- defining the terms of trade to protect domestic agriculture by imposing price controls on agricultural products, and
- Compulsory delivery of agriculture commodities at very fixed prices.

The question is how much surplus should be transferred. In this regard, two opposing views can be discussed. One is that agriculture does not require large amounts of capital for its expansion. The other view is that the investment requirements for agricultural transformation are so large that there may be a need for a net flow of capital from non-agriculture to agriculture.

The Derg regime removed a great deal of surplus from the agricultural sector to supply both the urban consumers and its huge army with cheap foodstuffs. However, this surplus was used ineffectively. This indicates that the potential of the agricultural sector to produce surplus that could be transferable to the other sectors could be high.

iii. **It contributes to Gross Domestic Product**

Over the last four decades, the share of agriculture and allied sectors (fisheries and forestry) to the national GDP has been declining. The percentage share declined from 76 percent in the early 1960s to 45 percent in 2003/04. Consequently, it has been the major source of fluctuations in the Ethiopian economy.

iv. **It contributes to employment**

More than 80% of the Ethiopian populations earn their livelihood from agriculture (crop cultivation and livestock rearing activities). High population growth and low urbanization have been an increasing major challenge to this sector that it could not absorb the

growing surplus labor force. Neglect or less attention to urbanization and non-farm sector development has put the farm sector under a growing pressure. Nevertheless, it supports a large percentage of the labor force.

In the face of the increasing scarcity of other resources, particularly agricultural land, measures should be taken to improve labor productivity in the agriculture sector.

Structure of the Agricultural Sector

i. Farming Systems in Ethiopia

The agricultural sector of Ethiopia is composed of the crop-production, livestock, forestry, and fishery sub-sectors. About 65% of the sector's GDP comes from crop-production, while animal husbandry contributes 25%. The remaining 10% is generated from the allied sectors, forestry, fishing and others.

The national 2001/2002 Sample Agricultural Figures provides some data on the major agricultural production system. The report has identified three categories of farms. Currently, the following farming systems are widely practiced in Ethiopia.

- The smallholder farming system,
- The pastoral/nomadic system, and
- The modern commercial farming system.

a. The small holder farming system

It is the most important or dominant system. It accounts for more than 90 percent of the agricultural production and for about 95 percent of the total area under crop production. It is characterized by mixed farming.

The total numbers of households in this category were estimated to be about 10.58 million heads. The average household size stood at around 5 members per household. Over 86 percent of this community cultivates farmlands with areas less than 2 hectare each.

b. The Pastoral Farming System

About 40% of Ethiopia's land area is in the arid and semi-arid zones and is located in the lowlands, below 1,500 m. There rain-fed crop production is not possible because of low-level erratic rainfall, and people rely more on livestock for subsistence. The lowlands are home to about 20% of Ethiopia's cattle, 25% of the sheep, and 73% of the goats, plus about one million camels. These animals support some 5.5 million people.

In addition to feeding this population, the livestock in the range lands account for a major portion of the country's exports of live animals, in particular of cattle. Surplus sheep and goats sourced from the rangelands represent about 19% of the domestic supply.

Ethiopia's range lands are also important for wildlife. The main areas of wildlife concentration are in the southwestern part of the country, particularly in the Omo River basin and the Gambella region. In these areas, which have a high rainfall and fertile soils, tsetse infestation has greatly suppressed agricultural and pastoral activities. Although less abundant, wildlife also exists in the eastern part of the country, particularly in the

Awash Valley and in the southern rangelands. The conservation and development of these resources are carried out through the development of national parks, wildlife sanctuaries, and reserves. In addition, 14 controlled areas have been established, of which the largest is the Borena controlled hunting area.

There is not much documented information about this system of farming. Most of the people are nomadic, moving seasonally, together with their livestock, from one place to another in search of pasture and water. Some studies have been undertaken about the pastoralists roaming in the Awash Valley, in connection with the development of medium-to large-scale irrigation schemes there.

Livestock production is much greater than crop production in the pastoral nomadic system. General and empirical observations suggest that this system is characterized by chronic food shortages. Thus, agricultural products and productivity are extremely low. With the possible exception of livestock vaccination, there is virtually nothing that the government (or any other, non-governmental organization) has provided for long in terms of assistance or support to the pastoral-nomadic system. However, these days, the sub-sector has been the focus of serious concern through the expansion of extension service.

c. **The Commercial Farming System**

Commercial farming system was *officially introduced during the third five-year plan (1968 – 73)* of the Imperial Government of Ethiopia. Among the strategies envisaged to modernize agriculture and increase marketable surplus, the plan stated that available government land would be utilized for the establishment of large commercial farms. As a result, many entrepreneurs rented and developed commercial farms in *the Awash Valley, the Rift Valley and other areas*. After the 1974 revolution, all these farms were confiscated by the government. Additional government lands in many parts of the country were also developed into large-scale state farms. These were organized into enterprises which in turn were grouped under corporations, according to their locations and output specialization. A separate ministry, the Ministry of State Farms Development was set up to manage and expand state farms. Also, another separate ministry, the Ministry of Coffee and Tea Development, was established.

The state farm enterprise introduced intensive farming and extensive mechanized agriculture. The former was based on irrigation, while the latter was marked by rain-fed agriculture, with or without the use of fertilizers and other chemicals. It is based on bringing unused land, into cultivation a predominant feature of modern agriculture in Ethiopia prior to 1974.

State farms have been the most pampered of all production systems in Ethiopia. There had been no limit for these farms in terms of receiving land, agricultural inputs, credits, price incentives and marketing facilities. Despite all these advantages, they were unproductive and inefficient. The major characteristics of many of them were mismanagement, abuse of assets, corruption, etc. It must be noted that some of these farms were developed without adequate studies, resulting in huge financial losses. In

fact, most of the state farms were run on government financial resources.

This system, comprising about 5% of the total cropland area, together with co-operatives, accounted for less than 10% of total agricultural production.

The efficiency of state farms is extremely low, relative to the high expenditure made in establishing and operating them. The major crops grown in these farms include cotton, coffee, tea, sugarcane, fruits and vegetables.

The size and role of state farms declined after 1992 when the new government granted some of the state farms to nearby farmers and investors. At present, there are only 13 state farms. They produce mainly wheat, maize, cotton, coffee, and tea on 156,040 hectares of land.

Under the current economic policy attempted have been made establish commercial farms. Out of the total investment permits issued between 1992/93 and 1997/98, 1148 or 26.8% of them were in agriculture. However, only 508 projects became operational.

With the advent of market economy, the Federal Government has recognized the decisive role that private capital can play in the expansion and development of large-scale modern farming in order to enhance the supply of food and raw materials and to create employment opportunities. As a result, the role of state farms is expected to fall significantly. The state may operate those state farms that are strategic to the economy, jointly with domestic or foreign private capital. In order to encourage domestic and foreign private capital, without any capital limitation, the government is committed to creating an enabling environment.

Activity 3.3

1. What are the main sectors of the Ethiopian economy?
2. Identify the types/structure of agriculture practiced in your area
3. What is the role of the agricultural sector in GDP?
4. List out the advantages that the society can get from the agricultural sector

Self-test exercise.

Dear distance learner, please summarize the different components of GDP from your locality or country. Did you try? Great job!

Suggested Answers

1. *Ethiopian agriculture is characterized by land fragmentation. Farmers own small sized farmland (around 0.5 ha) on which they cultivate rain-fed crops waiting for the good rainy season. It is a subsistence farming. Please teacher, customize this with their locality (all year rain areas where cultivating almost three times a year is possible, dry areas where livestock rearing is possible, irrigation areas where cultivating for market is possible, etc.)*
2. *Agriculture is the source of their food, agriculture is where they get employment, agriculture is where they get additional income by selling their surplus crops, etc.*

3.4. The Industrial Sector in the Ethiopian Economy

Section overview

Industries are more productive than agriculture. Developed countries are more industrialized than developing countries. To achieve faster economic growth, industrialization is the right option, but it is not such easy to industrialize. In this section you will learn more about this sector's contribution and its challenges in Ethiopia.

Section learning outcomes

By the end of this section, students will be able to;

- Describe the main features of the industrial sector of Ethiopia,
- Analyze the major problems of the industrial sector in their locality
- Examine the role of the industrial sector to the economy of Ethiopia

Key Concepts

Industry; Manufacturing; Mining; Large scale manufacturing; Medium scale manufacturing; Construction



Start Up Activity

What comes to your mind when you think of industrial sector of Ethiopia?



The Ethiopian industrial sector has been small compared to the agricultural and service sectors. This could be due to the short history of industrialization in the country. Its growth was modest, not exceeding 6.7 percent for the last four decades except during the years from 1997/98 to 2009/2010. (Belayneh, Weldeselassie, Legesse, Tasew, Denu, & Bansal, 2011).

The industrial sector is dominated by three sub-sectors. manufacturing (38%), construction (25%), and electric and water supply (18%). The remaining sub-sectors, electricity, mining and quarrying, etc., constitute the remaining 19%.

Main Features of the Industrial Sector

- The sector contributes about 13% of GDP and 9.5% of employment.
- There are about 130 state-owned and 7,000 private manufacturing industries of all sizes, mainly engaged in the production of consumer goods. Main products of these manufacturing industries include.
 - textiles, foodstuffs, tobacco, beverages, cement, leather and leather products, wood, metallic and non-metallic products, paper, plastic, tiles, clothing/apparel, canned and frozen meat, sugar and molasses, oil cakes and petroleum products.
- The growth performance of the industrial sector saw an appreciable improvement in recent years, compared to the average growth rate of 6.7% over the 10 years 2001/02 -2009/10.

Looking at the growth performance of each sub-sector, the construction sector registered the highest growth rate between 2002 - 2010. It averaged about 13% per year in 2006 - 2010, compared to only 4.6% between 1991/92 and 2005/06. Large- and medium-scale industries recorded the second highest growth rates.

Major Problems in the Sector;

- Low industrial base
- Low productivity level
- Underutilization of capacity
- Shortages of foreign exchange, new investment, raw materials and spare parts
- Very low level of technology/high dependence on imported technology
- Low-level skills and management

Roles of the Industrial Sector to the Ethiopian Economy

According to the International Standards for Industrial Classification (ISIC), the Ethiopian industrial sector is composed of mining and quarrying, manufacturing, electricity, water supply, and construction. During the years 1991/92 - 1997/98, large- and medium-scale manufacturing contributed 38.4% of the gross value of industrial production, while small-scale manufacturing and handcrafts contributed around 18.7%. The contributions of mining, quarrying, and electricity-supply activities were 3.9%, 15.8%, and 23.2%, respectively. From this we can conclude that the manufacturing sub-sector dominated the Ethiopian industrial sector, providing more than 57% of the sectoral output.

Since the manufacturing sub-sector is the most dominant and dynamic component of the industrial sector, and also due to availability of time series data, we will concentrate on this sub-sector as we analyze the contribution of the industrial sector to the national economy.

i. Out Put Contribution

According to ISIC, the manufacturing sector is characterized by the physical or chemical transformation of materials or components into new products, whether the work is performed by power-driven machines or by hand, and whether it is done in a factory or in the worker's home.

Food and beverages accounted for about 48% of the gross value of output of manufacturing establishments in 2007/08, followed by *non-metal* (17%) and *chemicals* (9%). These three industrial activities accounted for more than 74% of the entire gross value of products in large- and medium-scale manufacturing organizations during the same period.

In terms of the value added by the large- and medium-scale industry sub-sector, the food and beverage industrial group is the leading one. For example, in 2007/08, the contribution of the food and beverage industrial group was 50.7%.

Looking at the data on revenue obtained from sales, the food and beverage industrial group generated around 8.3 billion Birr, which is close to 48.5% of the total revenue obtained from large and medium scale manufacturing in 2007/08. (Belayneh,

Weldeselassie, Legesse, Tasew, Denu, & Bansal, 2011).

ii. **Employment Contribution**

The industrial sector, in general, and the manufacturing sub-sector, in particular, serves as important sources of employment, especially for the rapidly growing urban population in Ethiopia. In 2007/08, there were 1,677,906 persons engaged, out of which 678,911 were employees in the industrial sector. The number of persons engaged and employees during this period showed an increase of 6.4 and 5.8 percent, compared to that of 2006/07, respectively. These increases in the number of persons engaged and employees could be attributed to the increase in the number of establishments created in 2007/08. (Ibid).

When we examine the employment capacity of each industrial group in the manufacturing sector, as of 2007/08.

- The food and beverage group employed 50%,
- The non-metal, and paper and printing industrial groups contributed 14% and 10.9% of the sector's employment, respectively.

These three industrial groups, together, employed close to 75% of the total workforce in the manufacturing sub-sector for the year 2007/08.

The relative importance of the rest of the industrial groups, in terms of employment, varies between 2.1% in wood and furniture manufacturers to 8.8% in textile-product manufacturers. The decline in the share of employment of these sectors is mainly due to increased employment opportunities in other industrial groups such as in non-metal, paper and printing.

iii. **Foreign Exchange Contribution**

More than 90% of the nation's foreign currency earnings come from the agricultural sector. The poorly developed industrial sector of Ethiopia contributes very little to the foreign currency earnings of the nation.

Textiles generate 41.5% of the sector's foreign exchange, which is the largest contribution. Food and beverages, leather and footwear follow as the second and third with 32.9% and 10.8%, respectively. This pattern has remained almost the same in recent years. The only noticeable change is in the wood and furniture and chemical groups. The total value of wood and furniture and chemical exports in 2007/08 was Birr 43,269.7 and 30,198.9, respectively. This can be taken as an indicator of the potential the nation has in bringing in foreign currency from non-traditional commodities.

The benefits for the Ethiopian manufacturing sub-sector from preferential treatment which the developed world offers are great. In this regard, The *Africa Growth and Opportunity Act (AGOA)*, which allows some developing countries, including Ethiopia, to have access to the US textile market without tariffs and quotas, is the most notable opportunity. European countries are also opening their markets to African manufactured products. For instance, Ethiopia can now sell its sugar products in European markets. Therefore, the nation should try its best to benefit from these and other preferential

treatments which the developed world is offering to the poorest nations of Africa.

Activity 3.4

1. List out products of the industrial sector from your area
2. What major problems does the industrial sector in your surrounding have?
3. Summarize the roles of the industrial sector for the economy of Ethiopia

Self-test exercise.

Dear distance learner, please list products of industries or factories in your locality or country. Also summarize roles of the industrial sector for the economy of Ethiopia Did you try? Great job!

Suggested Answers

- *Cement from cement factories, sugar from sugar factories, clothes from textile industries, etc.*

Cement factories in Ethiopia include Mughar cement factory, Dangote cement factory, Mosobo cement factory, Capital Cement Factory, Habesha Cement factory, etc.

Sugar factories include Finche'a Sugar, Metehara Sugar, Wenji Shoa sugar, Omo Kuraz Sugar factory I, II & III, Kesseme Sugar Factory, Aiji Dediessa Sugar Factory, Tendaho Sugar Factory, Tana Beles Sugar Factory, etc factories.

Textile industries include Adam Spinning Factory, Edget Yarn Sewing Thread Sh.Co, Alemgena Textile P.L.C, Al-Star Industries P.L.C, Ethiopian Sewing Thread Factory S.C, Almeda Textile P.L.C, Awassa Textile S.C, Arbaminch Textile S.C, Ayka Addis Textile & Investment Group, Bahirdar Textile S.C, Bekimar Industry P.L.C (Desta Garment), Debre Berhan Blanket Factory PIC, DH Geda Blanket Factory PLC, etc.

Roles (benefits) of the industrial sector include out puts or products, employment opportunity and foreign exchange earnings, etc.

3.5 The Service Sector in the Ethiopian Economy



Overview

Hotels, tourism, education, health, etc are considered as services. Services are very crucial like the other previous sectors. In this section you will learn more about this sector and its contribution to the Ethiopian economy.



Learning outcomes

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

- Describe the service sector of Ethiopia
- Analyze the main features of the service sector in their locality
- Evaluate the role of the service sector to the economy of Ethiopia

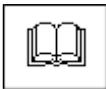
Key Concepts

Service sector; Tourism; Education; Medical services; Cultural heritages



Start Up Activity

1. What is the service sector?
2. What is the difference between agriculture, industry and service sectors?



Service sector is composed of various sub-sectors that range from wholesale and retail trade, to restaurants and to education and health service provision. More specifically, the service sector includes.

- wholesale and retail trade,
- hotels and restaurants,
- transport and communication,
- banking and insurance,
- public administration and defense,
- education,
- Health, domestic and other services.

Main Features of the Sector

- The sector's share in GDP was 45.1% during 2008/09.
- A relatively small percentage of population (about 10%) has been engaged in the services sector.
- The large contribution of the sector to the GDP comes mostly from government employment.
- Significant achievements have been made in areas of health, trade, tourism, banking and insurance in the past few years.
- Growth Performance. The growth in the services sector has been significant following

the reform carried out in the early 1990s. Consequently, its growth rate and hence its share in GDP has progressively increased during the last two decades.

Roles of the Service Sector to the Ethiopian Economy

The service sector plays an important role in the country's economy. Its contribution can be seen from three angles, namely- *output, employment, and foreign exchange contributions.*

i. Out Put Contribution

The service sector has played a dominant role, next to the agriculture sector, in the Ethiopian economy. But in 2008/09 and 2009/10, the output contribution of the service sector in Ethiopia dominated the agriculture sector, contributing about 45% and 46% respectively.

ii. Employment Contribution

In Ethiopia, the service sector is the second largest sector, next to agriculture, in terms of absorbing a significant part of the labor force. About 1.4% of the total labor force is employed in the health and education sectors, while about 0.5% is employed in the communication and transport sectors.

In Ethiopia, a significant number of mostly permanent employment opportunities are being created because of the rapidly growing economy. In particular, employment opportunities are being created by.

- Sustained government efforts to enhance private sector investments;
- The big push in infrastructure development;
- The expanding services industry; and
- The rapid growing horticulture sector

iii. Foreign Exchange Earnings

The value of exports of services increased from \$261 million in 1980 to \$348 million in 1998, representing an average growth rate of 33%.

In 2008/09, foreign exchange income earned from service providers such as *Ethiopian Airlines and Ethiopian Shipping Lines*, as well as from various service sub-sectors such as *tourism, communication, insurance and financial services*, collectively reached nearly 2 billion dollars, when compared to just 1.5 billion dollars for the export of goods.

Components of the Service Sector

The service sector or the service industry is one of the three main economic sectors. The basic characteristic of this sector is the production of services (also known as 'intangible goods'), and does not include the goods-producing sector.

This sector is composed of various sub-sectors. More specifically, the service sector includes. trade, hotels and restaurants, transport and communication, education, banking and insurance, public administration and defense, health, and other services.

According to the Ethiopian National Income Account classification, the first five sub-sectors are referred to as distributive services while the remaining are in the 'Other'

service sector.

According to the 2009/10, MOFED Report the GDP share of the service sector increased from 41.1% in 2002/03 to 46% in 2009/10. This is mainly the result of the fast growth in the areas of real estate, hotel and restaurant, education, and health. In contrast, the share of agriculture fell from its level of 56.7% in 1995/06 to 42% in 2009/10.

There are a number of ways to consider the service sector such as. its divisions, its components, and the types of activities within the components. Accordingly, the service division includes a wide variety of industries, but they can be categorized into primarily consumer-oriented (providing a service directly to a consumer), primarily business-oriented (providing a service directly to another business) or mixed (providing services to both businesses and individual consumers).

Alternately, the activities of the services division can be described in reference to their economic activities. Accordingly,

- Physical activities- involve working with objects; examples include repairing cars, hairdressing, and cooking.
- Intellectual activities- involve providing education or training at such levels as university and vocational school.
- The aesthetic activities- entail providing consumers with artistic experiences such as offered by museums, theater performances, art shows, and musical performances.

Activity 3.5

1. List out the services that you know from your area provided by the service sector
2. What major features characterize the service sector in your area?
3. Summarize the roles of the service sector to the economy of Ethiopia



Self-test exercise 3.5

Dear distance learner, please list services provided by the service sector in your locality or country. Also summarize roles of the service sector for the economy of Ethiopia. Did you try? Great job!



Suggested Answers

- List out the services that you know from your area provided by the service sector
 - Health service by clinics, health centers and hospitals
 - Education service provided by schools, colleges and universities
 - Entertainment services provided by hotels, tour guides, etc
- In a group of four students evaluate the roles of the service sector to the economy of Ethiopia

The share of service sector out of GDP is the highest followed by agriculture and manufacturing industries. Therefore, the service sector role is very much significant in the Economy of Ethiopia.

3.6. Agriculture versus Industrial Development



Overview

Agriculture and industrial development are interlinked. The question of which one to give priority to is always debatable. Ethiopia is agricultural resource endowed but the sector is not productive enough to bring fast economic growth. Industry is highly productive but a lot more expensive. You will learn more on this in this section.



Learning outcomes

By the end of this section, students will be able to;

- Differentiate between agricultural development and Industrial development strategies.
- Evaluate the agricultural Development Led Industrialization (ADLI) strategy of Ethiopia.

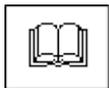
Key Concepts

Agricultural development; Industrial Development; ADLI strategy



Start Up Activity

Compare agricultural versus industrial development strategies?



As records reveal, the agricultural sector in Ethiopia is the mainstay of the country's economy. It is also the most volatile sector, as exhibited in the unevenness of its growth patterns, which is the effect of its heavy dependence on rainfall and the seasonal shocks that are frequently observed in Ethiopia. However, it contributes the largest share to the GDP, export trade earnings, and employment. It also provides raw materials for the various industries in the country to a great extent. With this scenario, the various strategies so far adopted to develop it need rethinking. This serious work of rethinking the development priorities should be made considering the various regional as well as local objective conditions.

Different views or paradigms have been adapted for the development of a country. The role of agriculture in economic development has been considered as largely passive and supportive or secondary. In the Western economies, the industrial sector was given priority, based on the assumption that it has the largest potential to adopt technology and to create forward and backward linkages with the other sectors.

However, the desirability of placing such heavy priority on industrial growth is questionable for most developing countries like Ethiopia. Since the 1970s, development economists

have come to realize that the agricultural sector needs to be viewed as a leading and dynamic sector. They further state that, without the development of the agricultural sector, the growth of the industrial sector will become weak. Hence, the agricultural sector has to be the leading sector, and this is the approach of the current Ethiopian strategy of development, ADLI.

 **Activity 3.6**

1. Is Industrial development strategy better than agricultural development strategy for faster economic growth for Ethiopia or the reverse, critically argue.
2. Evaluate the ADLI strategy of Ethiopia.

 **Self-test exercise 3.6**

Dear distance learner, please critically argue whether industrial development strategy or agricultural development strategy is better for faster economic growth. Also critically evaluate the Agricultural development Led Industrialization (ADLI) Strategy of Ethiopia. Did you try? Great job!

 **Suggested Answers**

1. Whether agricultural development strategy or industrial development strategy leads to faster economic growth depends on what resources you have in abundance. Agriculture requires agricultural resources endowment whereas industry requires heavy machinery and high technology.
2. ADLI is not a success, that is why we proceeded to Industrial parks development without agriculture developing!!

 **Check List**

Dear distance learner, we hope you enjoyed working on this section. Now it is time to check your understanding about evolution of money. Read each question and put a tick (✓) mark in the 'yes' or 'no' box, which helps you decide on your level of understanding of the points presented so far.

Objectives	Yes	No
Can you describe Components of the Gross Domestic Product (GDP)		
Can you differentiate Real GDP Vs Nominal GDP		
Can you describe the Agricultural Sector in the Ethiopian Economy		
Can you describe the Industrial Sector in the Ethiopian Economy		
Can you describe the Service Sector in the Ethiopian Economy		

Dear distance learner, did you mark any box under the 'No' column? If so, please look at the corresponding item to the left and go back to your text and read about it.



Unit Summary

To understand how the economy is using its scarce resources, economists study the composition of GDP among various types of spending. To do this, GDP (which we denote as Y) is divided into four components: consumption (C), investment (I), government purchases (G), and net exports (NX).

When studying changes in the economic performance of a country over time, economists want to separate the nominal effect and the real effect of this change. In particular, they want a measure of the *total quantity of goods and services* the economy is producing *that is not affected by changes in the prices of those goods and services (RGDP)*.

On the eve of the February 1974 revolution, the state of the Ethiopian economy *exhibited respectable moderate rates of growth of GDP and per capita GDP*, although it had begun to show signs of deceleration towards the end. The domestic savings ratio was growing and *Ethiopia had a comfortable balance of payments position and low inflation*.

The agricultural sector is the mainstay of the Ethiopian population, in which more than 85 percent of the people work.

The FDRE adopted a strategy of Agricultural Development- Led Industrialization (ADLI) to transform the agricultural sector and promote economic development.

The agricultural sector, though dominant, is facing problems that have deterred it from meeting national requirements. The problems are both social and natural. The social (human-made) problems are related to allocation of resources and decision-making, while the natural ones relate to recurring and unexpected weather conditions.

Based on NBE's annual report of 2019/20, of the share of sectors in GDP from 2014/15 to 2019/20, agriculture's share in GDP has decreased from 40% to 33%, Industry's share in GDP has increased from 21% to 29% and service sector's share in GDP has almost been 40% for the past six years.

Different views or paradigms have been adapted for the development of a country. The role of agriculture in economic development has been considered as largely passive and supportive or secondary. In the Western economies, the industrial sector was given priority, based on the assumption that it has the largest potential to adopt technology and to create forward and backward linkages with the other sectors.



Unit Review Exercises

I. Write true if the statement is correct or False if not correct for each of the following questions.

1. Agriculture is Source of raw materials for non-agro-based industries
2. Agriculture is Source of food supply for industrial sector
3. Agriculture is Source of foreign currency earnings for a country
4. Ethiopia's dominant farming structure is the large-scale animal husbandry
5. Ethiopia's dominant farming structure is State farms
6. Ethiopia's dominant farming structure is the smallholder farm system
7. Ethiopia's dominant farming structure is the collective farm system

II. Choose the best answer from the given alternatives.

1. Which of the following is true for Ethiopia?
 - A . Agricultural development is more important than industrial development.
 - B . Agricultural development is less important than industrial development.
 - C . Agricultural development is equally important to industrial development.
 - D . None of the above
2. The current developmental strategy adopted in Ethiopia is _____
 - A . Industrial Development-Led Agriculture Strategy (IDLA).
 - B . Agricultural development led industrialization (ADLI)
 - C . Home grown economic reform agenda
 - D . All of the above
3. Which of the following is true regarding cereal production in Ethiopia?
 - A . Cereal production ranks second, next to oil seed production, in terms of volume of output.
 - B . Cereal production ranks first to oil seed production, in terms of volume of output.
 - C . Cereal production is equal to oil seed production, in terms of volume of output.
 - D . None of the above
4. Which of the following is true regarding European demand for Ethiopian cut flowers?
 - A . The European demand for the cut flowers of Ethiopia has little effect on the promotion of floriculture in Ethiopia.
 - B . The European demand for the cut flowers of Ethiopia has significant effect on the promotion of floriculture in Ethiopia.
 - C . There is no demand for the cut flowers of Ethiopia in Europe
 - D . None of the above



Answers to Activities

The following are possible answers to the activities in unit Three.

Activity 3.1

1. Consumption (C) includes all the household expenditures except expenditure on building a house. Expenditure on foods, clothing, schooling, etc. make them list as much as they can!! Investment (I) includes firms' expenditure on their production of goods and services; payment for workers, rents, warehouse, etc. Government Expenditure (G) includes all the payments by the government (federal as well as regional) on their day-to-day activities. Exports (X) include all the goods and services sold outside while Imports (M) includes all the goods and services purchased from outside.

Activity 3.2

Prices and Quantities					
Year	Price 'commodity 1' in Birr	Quantity 'commodity 1' in Units	Price of 'Commodity 2' in Birr	Quantity of 'Commodity 2' in Units	Total
2013	150	150	250	100	
2014	150	200	300	150	
2015	150	250	350	200	
(1) Nominal GDP = $\sum Q_i P_i$					
2013	22500		25000		47500
2014	30000		45000		75000
2015	37500		70000		107500
(2) Real GDP (base year 2013) = $\sum Q_i P_{base\ year}$					
2013	22500		25000		47500
2014	22500		30000		52500
2015	22500		35000		57500
(3) GDP Deflator (%) = $\frac{NGDP}{RGDP} \times 100$					
2013					100
2014					143
2015					187

Activity 3.3

1. Ethiopian agriculture is characterized by land fragmentation. Farmers own small sized farmland (around 0.5 ha) on which they cultivate rain-fed crops waiting for the good rainy season. It is a subsistence farming. Please teacher, customize this with their locality (all year rain areas where cultivating almost three times a year is possible, dry areas where livestock rearing is possible, irrigation areas where cultivating for market is possible, etc.)

2. Agriculture is the source of their food, agriculture is where they get employment, agriculture is where they get additional income by selling their surplus crops, etc.

Activity 3.4

- *Cement from cement factories, sugar from sugar factories, clothes from textile industries, etc.*

Cement factories in Ethiopia include Muger cement factory, Dangote cement factory, Mosobo cement factory, Capital Cement Factory, Habesha Cement factory, etc.

Sugar factories include Finche'a Sugar, Metehara Sugar, Wenji Shoa sugar, Omo Kuraz Sugar factory I, II & III, Kesseem Sugar Factory, Arji Dediessa Sugar Factory, Tendaho Sugar Factory, Tana Beles Sugar Factory, etc factories.

Textile industries include Adam Spinning Factory, Edget Yarn Sewing Thread Sh.Co, Alemgena Textile P.L.C, Al-Star Industries P.L.C, Ethiopian Sewing Thread Factory S.C, Almeda Textile P.L.C, Awassa Textile S.C, Arbaminch Textile S.C, Ayka Addis Textile & Investment Group, Bahirdar Textile S.C, Bekimar Industry P.L.C (Desta Garment), Debre Berhan Blanket Factory PIC, DH Geda Blanket Factory PLC, etc.

- Roles (benefits) of the industrial sector include out puts or products, employment opportunity and foreign exchange earnings, etc.

Activity 3.5

- List out the services that you know from your area provided by the service sector
 - Health service by clinics, health centers and hospitals
 - Education service provided by schools, colleges and universities
 - Entertainment services provided by hotels, tour guides, etc
- In a group of four students evaluate the roles of the service sector to the economy of Ethiopia
 - The share of service sector out of GDP is the highest followed by agriculture and manufacturing industries. Therefore, the service sector role is very much significant in the Economy of Ethiopia.

Activity 3.6

1. Let them debate and the teacher should chair their debate. Whether agriculture or industry depends on what resources you have in abundance. Agriculture requires agricultural resources endowment whereas industry requires heavy machinery and high technology.
2. ADLI is not a success, that is why we proceeded to Industrial parks development without agriculture developing!!



Answer for Review Exercises

II. True/False

1. True
2. True
3. True
4. False
5. False
6. True
7. False

II. Choose the best answer from the given alternatives.

1. A
2. C
3. B
4. B

Unit 4

Business Startups and Innovation



Unit Introduction

Innovation is no longer a buzzword. More than ever, it is a critical element in fueling business growth and maintaining market share. The commercial benefits of innovation are well known. Today, however, there is an added urgency in businesses' efforts to devise and execute on new ideas. Increasingly, they are faced with the risk of disruption from many known and unknown sources. How businesses respond is critical to their continued success and ultimately, their existence.

With this in mind, this unit will discuss such contents like *Innovation, business startups and Cost Benefit Analysis*.



Unit Outcomes

By the end of this unit, students will be able to.

- ◆ Define innovation
- ◆ Analyze innovation and its determinants
- ◆ Explain the main components of a business plan
- ◆ Distinguish among different businesses organizations
- ◆ Review a business plan
- ◆ Write a sample business feasibility analysis

The Required Study Time for this unit is 10 Hours

Unit Learning Strategies

Dear distance learner, remember each unit has a self-study format. The following learning strategies will help you study this unit.

- Reading the topics
- Doing various activities
- Completing written exercises
- Activities based on the learner's experience
- Extra-curricular learning
- Scenario-based activity
- Auto tutorial instruction

4.1 Innovation



Overview

Businesses start with inventions. Creativity is a mother of all businesses. When inventions are converted into marketable products or services it is called innovation. In this section, you will learn about innovation in some brief detail.



Learning outcomes

By the end of this section, students will be able to;

- Describe innovation
- Examine the types of innovation
- Explain the destructive role of innovation

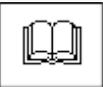
Key Concepts

Innovation; Product, process, market, eco-, organizational, Innovations; Creative destructions



Start Up Activity

What is innovation?



The Oslo Manual, an international reference guide from the OECD for collecting and using data on innovation, defined the concept of innovation as.

“(...) a new or improved product or process (or a combination thereof) that differs significantly from the unit’s previous products or processes and that has been made available to potential users (product) or brought into use by the unit (process).”

Innovation can be defined as something new, improved or introduced that creates value. It can be summarized into two key elements. creativity and implementation.

Types of innovation

According to the 4th and most recent edition (2018) of the Oslo Manual, there are four main types of innovation.

i. Organizational Innovation

Organizational innovation refers to the development of a new organizational strategy that will somehow change a company’s business practices, as well as the way its workplace is organized and its relationship with external stakeholders.

Examples

- The first companies adopting a four-day week working schedule of only 4 days per week
- The first companies that started to use the power of digital and allowing employees to skip the office and work from home (depending on the role)

ii. **Process Innovation**

Process innovation is about implementing a new or improved production or delivery approach, including changes in operational methods, the techniques used and the equipment or software.

Examples

- The first firms betting on SaaS (software as a service) technology, and using, for instance, cloud contact centers from Talk desk, changed the way their customer support processes used to be organized
- The first hotels that decided to make decisions based on big data using, for instance, insights from the Clumber Hotel, made changes on their decision-making approach

iii. **Product Innovation**

Product innovation is the introduction of a new or improved good or service. These inventions or changes may have to do with improving technical specifications, the materials or the software used or even advancing on UX (user experience). However, product innovations don't need to improve all functions or performance specifications. An improvement to or addition of a new function can also be merged with a loss of other functions or the downgrade of some other specifications.

Moreover, a product innovation must add available to potential users but doesn't necessarily need to generate sales. Because if it did, then innovations with low demand or, for instance, digital products like apps that are free would be excluded. At the same time, routine changes or updates aren't considered product innovations as they are only correcting errors or making some seasonal changes.

Examples

- Lego has been changing the materials of its famous bricks to biodegradable oil-based plastics
- The first electric vehicles introduced in the car's market were also an innovation, and new batteries with longer ranges that keep coming out are also an example of innovation

iv. **Marketing Innovation**

Marketing innovation means developing a new marketing strategy that produces changes in, for instance, the way a product is designed or packed, or even other decisions regarding price or promotion.

Example

- Haagen Dazs' new waste-free container

v. **Eco Innovation**

Eco-innovation is an innovation resulting in significant progress towards the 2030 goals sustainable development established by the UN. In practice, it means reducing the impacts of our production modes on the environment, improving nature's resilience to

environmental stresses, or achieving a larger efficient and responsible use of natural resources.

In this way, we can say eco-innovation may create value in two different areas. First, from a sustainable development perspective, as it promotes sustainability throughout a product's entire life cycle, it helps to address challenges such as climate change, resource scarcity, and biodiversity. Second, it can also boost a company's performance and competitiveness. By embracing new and greener processes, technologies and services, eco-innovation can help organizations access new markets, increase productivity and profitability across the value chain, strengthen their reputation or attract new investors.

Example

- A while ago, Procter and Gambler realized householders could save on their electricity bill by switching to cold-water washings and started developing cold-water detergents (product innovation)
- As part of its sustainability strategy, IKEA is changing its fleet to electric vehicles (process innovation)
- Nestle's new paper-based straws as an alternative to plastic straws (marketing innovation)

The first companies concerned with the sustainability of their operations that decided to change their suppliers and partners if they don't prove they are also making efforts to become more sustainable (organizational innovation).

Innovation is also destructive, not only creative!

Schumpeter (1934) brought into discussion several arguments on how businesses search for new opportunities and competitive advantage. One of his most famous arguments has to do with the concept of "creative destruction". In Schumpeter's vision, capitalism is a dynamic and innovative market system that is constantly changing. These changes, he says, happen because of new ideas and processes that take over the current paradigm (status quo) and create new ways of producing goods, services or entirely new industries.

The claims destruction and imbalance are what makes capitalism develop and grow, and not the usually accepted idea of economic equilibrium. In this way, the Austrian economist calls this imbalance "creative destruction" because innovation often leads to market chaos. For instance, products get obsolete, companies close and people get unemployed. Still, he believes these are necessary consequences for new solutions that increase life quality to come to light.

We've been watching these examples of creative destruction across humankind's history. We've gone over the first industrial revolution to the boom in using petroleum and we today we are a highly technological society of information. These periods of innovation make the old models obsolete and create the need for everyone and everything to innovate – and the transformation is drastic.

From a business perspective, only companies with a great strategic vision survive an episode of creative destruction. Companies like Nokia and Kodak, that were once

market leaders in their own industries, failed to see how the cellphone and photography industries would change. At the same time, from a sustainability strategy, as we've discussed upper on this article, companies making radical changes and developing true sustainability strategies (from managing waste in a circular way to using renewable energy) will probably be the ones thriving in the future.

Examples of Famous Innovators

- Steve Jobs starting developed the smartphone world with the iPad
- Marie Curie made great researches on radioactivity
- Elon Musk has been making great progress on luxurious electric cars
- Ann Kiessling made plenty of findings on the area of biology
- Nikola Tesla worked on the production, transmission, and application of electric power
- Amanda Jones was the inventor of a vacuum method of canning
- Alexander Graham Bell invented the first telephone



Activity 4.1

1. Define innovation
2. List the innovations you know and tell its type
3. Have you observed any destructive role of innovation in your area? Explain it.



Self-test exercise 4.1

Dear distance learner, please define innovation. Also list some of the innovations you know and tell its type. Did you try? Great job!



Suggested Answers

- *Innovation is creation of new products, or new production process.*
- *BPR is a process innovation, KAIZEN is a process innovation, DRONE is a product innovation, etc.*

4.2 Business Startups

Section overview

Innovations when successful results in business startups. These are small businesses which are results of creativity/innovation supported by financial capital. This section teaches you more about business startups.

Section learning outcomes

By the end of this section, students will be able to.

- Describe the concept of business startups
- Differentiate small businesses from business startups
- Relate innovation and business startups

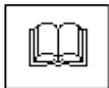
Key Concepts

Business Startups; Small businesses



Start Up Activity

What is business startup?



When an entrepreneur starts a business, they may see startups and small businesses differently. While these two types of businesses have a lot in common, there are some key differences that you should know about when creating your company so that you don't make any critical mistakes early on.

The initial decisions that you make when forming your business will fuel your early success or cause you to experience numerous hurdles at a time when you likely don't know how to navigate such problems. While there are no strict guidelines that determine what a startup is, the general definition of a startup is any company that's in the initial stages of operations but expects significant growth in the near future.

For many organizations, innovation is difficult to understand and execute. There remains a clear discrepancy between how big business and start-ups approach it. As a result, big business is looking to start-ups and entrepreneurs to identify disruptive ideas and opportunities for their business, and to unlock innovation through the spirit, blood, sweat and tears of entrepreneurship.

On the other hand, a small business is any kind of business that only has a certain number of employees, the maximum of which differs by industry. Though these types of businesses may sound the same, understanding the differences between the two will be integral to your future success as an entrepreneur.

Startups are entirely different than small businesses when it comes to business growth and revenue. For instance, startups are focused primarily on top-end revenue and growth potential. A startup is considered to be a temporary business model wherein the focus is

on rapid growth. Unlike a small business, there are no restrictions or limitations placed on growth. While small businesses are perfectly content with operating in a small portion of a large market, startups usually want to obtain as much market share as they can with the product or service that they provide.

Startups won't be profitable in the initial stages of business development since they want to grow within the shortest time possible. It will sometimes take years for a startup to make its first dollar of profit. The main goal is to create a product or service that can be successfully placed on the market, which could bring in millions of dollars of profit in the long run. Among the most successful startups is *Uber*, which now has a market value of \$50 billion. Whether your goal is to create a *small business or startup*, you should know the difference between these two business types when forming your own company.

Startup businesses are attempting to create a product or service that's viable on the market, they will usually need to put in significant amounts of capital for product development, which usually can't be done without the right investments. In many cases, startups will obtain funding from angel investors or venture capital firms.

Funding for most startups involves *seed funding*, which means that the startup will approach potential angel investors for money. These investors are individuals who want to invest in a company that they believe is going to eventually make it big. These investors will get a share of the business for their money, which usually equates to 5-10 percent.



Activity 4.2

1. Define startup businesses
2. Differentiate startup businesses from small businesses
3. What is the relationship between innovation and business startups?



Self-test exercise 4.2

Dear distance learner, please define startup businesses. Also differentiate startup businesses from small businesses. Did you try? Great job!



Suggested Answers

- *Startup businesses are new businesses coming as new based on innovations.*
- *Small businesses do not necessarily need innovation like startups.*

4.3 Types of Businesses Organizations



Overview

The process of production is conducted by the use of business organizations. The production can be either goods production or service rendering. There are different types of such business organizations. This section is all about types of business organizations.



Learning outcomes

By the end of this section, you will be able to.

- ◆ Identify different forms of business organization;
- ◆ Explain features, advantages and disadvantages of different forms of business organizations;
- ◆ Discuss the factors determining choice of an appropriate form of business organization.

Key Concepts

Sole Businesses; Corporations; Partnership Businesses



Start Up Activity

- What are businesses organizations?
- What are the types of business organizations?



Business organizations may be owned and managed by a single individual or group of individuals who may form a partnership firm or a joint stock company. Such arrangement of ownership and management is termed as a form of business organization. A business organization usually takes the following forms- sole ownership, partnership business and Corporations.

4.3.1 Sole Proprietorship

The term 'sole' means single and 'proprietorship' means ownership. So, only one person is the owner of the business organization. This means that a form of business organization in which a single individual owns and manages the business, takes the profits and bears the losses, is known as sole proprietorship form of business organization. A type of business unit where one person is solely responsible for providing the capital and bearing the risk of the enterprise, and for the management of the business. It is very simple to establish a sole proprietary concern. Any person who is willing to start a business and has the necessary resources can set up this form of business organization. To start and operate the business in this form, practically does not require any legal formalities to be fulfilled. In some cases, like restaurant, chemist shop etc. however, permission from the competent authority is required to be obtained before starting the business.

Characteristics of Sole Proprietorship Form of Business Organization

- a) *Single Ownership*- This business organization has a single owner who himself/herself

starts the business by bringing together all the resources.

- b) *No Separation of Ownership and Management.* The owner himself/herself manages the business as per his/her own skill and intelligence.
- c) *Less Legal Formalities.* The formation and operation of a sole proprietorship form of business organization does not involve any legal formalities. Thus, its formation is quite easy and simple.
- d) *No Separate Entity.* The business unit does not have an entity separate from the owner. The businessman and the business enterprise are one and the same, and the businessman is responsible for everything that happens in his business unit.
- e) *No Sharing of Profit and Loss.* The sole proprietor enjoys the profits alone. At the same time, the entire loss is also borne by him. He alone bears the risks and reaps the profits.
- f) *Unlimited Liability.* The liability of the sole proprietor is unlimited. In case of loss, if his business assets are not enough to pay the business liabilities, his personal property can also be utilized to pay off the liabilities of the business.
- g) *One-man Control.* The controlling power of the sole proprietorship business always remains with the owner. He/she runs the business as per his/her own will.

Advantages

- ❖ Easiest to get started
- ❖ Greatest freedom of action- Flexibility in Operation
- ❖ Maximum authority
- ❖ Income tax advantages in very small firms
- ❖ Maintenance of Business Secrets
- ❖ Quick Decision and Prompt Action
- ❖ Flexibility in Operation.
- ❖ Personal Touch.

Disadvantages

- ❖ Limited Resources.
- ❖ Lack of Continuity.
- ❖ Unlimited Liability.
- ❖ Not Suitable for Large Scale Operations.
- ❖ Limited Managerial Expertise.

4.3.2 Partnership

A partnership is a business owned by two or more persons who contribute resources into the entity. The partners divide the profits of the business among themselves. In *general partnerships*, all partners have unlimited liability. In *limited partnerships*, creditors cannot go after the personal assets of the limited partners.

Characteristics of partnership form of business organization Based on the definition of partnership as given above, the various characteristics of partnership form of business organization, can be summarized as follows.

- a) *Two or More Persons*- To form a partnership firm at least two persons are required. The maximum limit on the number of persons is ten for banking business and 20 for other businesses. If the number exceeds the above limit, the partnership becomes illegal and the relationship among them cannot be called partnership.
- b) *Contractual Relationship*- Partnership is created by an agreement among the persons who have agreed to join hands. Such persons must be competent to contract. Thus, minors, lunatics and insolvent persons are not eligible to become the partners. However, a minor can be admitted to the benefits of partnership firm i.e., he can have share in the profits without any obligation for losses.
- c) *Sharing Profits and Business*- There must be an agreement among the partners to share the profits and losses of the business of the partnership firm. If two or more persons share the income of jointly owned property, it is not regarded as partnership.
- d) *Existence of Lawful Business*- The business of which the persons have agreed to share the profit must be lawful. Any agreement to indulge in smuggling, black marketing etc. cannot be called partnership business in the eyes of law.
- e) *Principal Agent Relationship*- There must be an agency relationship between the partners. Every partner is the principal as well as the agent of the firm. When a partner deals with other parties, he/she acts as an agent of other partners, and at the same time the other partners become the principal.
- f) *Unlimited Liability*- The partners of the firm have unlimited liability. They are jointly as well as individually liable for the debts and obligations of the firms. If the assets of the firm are insufficient to meet the firm's liabilities, the personal properties of the partners can also be utilized for this purpose. However, the liability of a minor partner is limited to the extent of his share in the profits.
- g) *Voluntary Registration*- The registration of partnership firm is not compulsory. But an unregistered firm suffers from some limitations which makes it virtually compulsory to be registered. Following are the limitations of an unregistered firm.
 - 1) The firm cannot sue outsiders, although the outsiders can sue it.
 - 2) In case of any dispute among the partners, it is not possible to settle the dispute through court of law.
 - 3) The firm cannot claim adjustments for amount payable to, or receivable from, any other parties.

Advantages of Partnership form

- a. Easy to Form
- b. Availability of Larger Resources
- c. Better Decisions
- d. Flexibility
- e. Sharing of Risks
- f. Keen
- g. Benefits of Specialization
- h. Protection of Interest
- i. Secrecy

Limitations of partnership form

A partnership firm also suffers from certain limitations. These are as follows.

- ❖ Unlimited Liability
- ❖ Instability
- ❖ Limited Capital
- ❖ Non-transferability of share
- ❖ Possibility of Conflicts

4.3.3 Corporations

A corporation is a business organization that has a separate legal personality from its owners. Ownership in a stock corporation is represented by shares of stock. The owners (stockholders) enjoy limited liability but have limited involvement in the company's operations. The board of directors, an elected group from the stockholders, controls the activities of the corporation. In addition to those basic forms of business ownership, these are some other types of organizations that are common today.

In general, a corporation has all the legal rights of an individual, except for the right to vote and certain other limitations. Corporations are given the right to exist by the state that issues their charter.

Activity 4.3

1. Compare and contrast the three forms of business organizations.
2. List at least one business organization from your locality for the three types of business organizations,
3. What factors affect your personal choice of an appropriate form of business?



Self-test exercise 4.3

Dear distance learner, please compare the three types of business organization. Also give one example for each. Did you try? Great job!



Suggested Answers

1. Sole ownership business, Partnership business, and Corporations.
2. Any small shops – Sole ownership; any medium sized two/three owners owned businesses- Partnership; Banks, insurance companies, etc. are Corporations.

4.4 Business Feasibility Analysis

Section overview

Whether being able to run a business or not is determined by so many factors. Access to those factors makes one in a better off position compared to others who do not have them. This analysis is what is known as business feasibility analysis. This section is all about it.

Section learning outcomes

By the end of this section, students will be able to;

- ◆ Describe Cost benefit Analysis for business feasibility studies
- ◆ Explain business plan
- ◆ Develop a business plan
- ◆ Undertake cost benefit analysis of business startups

Key Concepts

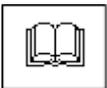
SWOT analysis; Cost Benefit Analysis; Business Plan



Start Up Activity

Do you think all the business ideas get started, why or why not?

4.4.1 Feasibility Studies versus business plans



Be sure you know what you want and what to expect when pursuing a new venture, business or project. A lot of time, resources and money can be saved in knowing what to do and the order in which to do it. A good rule of thumb is to never commission a business plan until a feasibility study has been completed first. A proof of business concept, also known as a feasibility study, is normally less than 20% of the cost of a business plan and although a feasibility study will not be anywhere close to the in-depth “nuts and bolts” view of a business plan, it will do exactly what the name implies. It will show if a project is feasible before any other steps are taken or major financial burden is incurred. There are very big differences between a feasibility study and a business plan.

4.4.2 Feasibility Studies

A feasibility study is designed to discover if a business or project is “feasible” or if it is not. (In short, does the business or project warrant further investment of time, money and further study or is it a non-starter). A feasibility study is a relatively inexpensive way to

safeguard any wastage of further investment (will it work or won't it). If a project is seen to be feasible from the results of the study, the next logical step is to commission a full business plan. Will the investment made in the feasibility study itself then be wasted? No. Because the research and information uncovered in the study will be of good use in the business planning stage and will also reduce the research time and therefore the cost of the business plan. On the other hand, a business plan is designed to "plan" in advance how a business or project will be started, implemented and managed. Business plans are commissioned for one of three reasons. Re-organization, investment/funding or a management blueprint for operation.

People never plan to fail; people only fail to plan! FEASIBILITY STUDIES demonstrate to a prospective project owner or investor that a given concept is financially viable and whether further study and/or a business plan is warranted. For a feasibility study, basic data is obtained through a series of queries, questions and meetings, wherein the client provides some of the research and other data and facts need to be gained from a variety of sources. The typical feasibility study contains, among other items, notes on financial projections, a general description of the business, general details describing how the company / project will be formed, managed and marketed, statements concerning the competition and a cash-flow projection based on averages. Further notes can be included as to general details of the project and revelations found during the research stage. The study will normally be completed quickly and in very general format compared to that of a business plan.

A feasibility study should answer five questions.

1. Will it work or not?
2. Is it profitable or not?
3. What will it basically cost to fund or start?
4. Is it worth doing?
5. Is it worth commissioning a business plan?

4.4.2 Business Plans

A business plan is a detailed road map for building a given company. A business plan contains all that the feasibility study has plus specific timelines, detailed budgets with forecasts, letters of intent, resumes of staff, background, competition, strengths and weaknesses, work sheets (with full supporting references and notations) and appendices. Appendices should include copies of all documentation in relation to key analyses as well as plans that together represent the road map for company development.

A well-written business plan will show exactly what revenues can be expected and when to expect them, what overheads and expenses will need to be paid and exactly when they will be due. It will also show staffing levels and salaries along with costs of employment, sales levels with monthly and seasonal trends, setup costs, building/office costs, utility and telephone costs, legal, insurance and accounting costs, office furniture and supplies costs and a myriad of other costs and projections. However, while these costs and revenues form an important part of the required picture, a business plan will also need to demonstrate that all required plans are completed.

As such a business plan will feature information central to establishing a high degree of certainty in effective operation. Sections on demographics, sales and sales methods, objectives, expansion plans, contingency exercises, product/services market introductions, regulatory requirements, laws of City, State and Federal governments relating to the business or project and much more should be included. A well-written business plan can help maximize potential and minimize overheads, liabilities and risk associated with any project. People never plan to fail; they only fail to plan! A feasibility study (proof of business concept) and a business plan are totally separate documents and each does a very specific job. The costs associated with each are also completely different.

However, a business plan may be developed that has as a component which includes key features and evidence supporting proof of the business concept.

4.4.3 Developing a Small & Medium Enterprise feasibility study

A SME feasibility study (proof of business concept) is a formalized, written approach to evaluating your business idea. It should;

- Show you what facts and figures are needed to aid decision- making.
- Show whether or not your idea is viable.
- Allow you to discover and look at alternative approaches and solutions to putting your idea into practice.

The Study should be written by you, for you, in language and in terms you can relate to about your business idea. It should include the following content.

1. The business idea

How would you describe your business idea? What is it? Will it work? How is it different from existing businesses? Who will buy from you? Can you put your idea on paper?

It is not enough simply to say “A Service business” or “A coffee shop”. Paint a picture of your business idea in words so that anyone reading this description knows exactly what you are talking about. To start your Feasibility Study - start with your business idea, on paper. Discuss it with others and adjust it as you obtain more information and ideas.

2. Profiles- Key People

It is not enough to have a good idea - you need people who can implement it. Who are they? Are they you, your partners, your family or anyone else? Once you have identified these people you need to determine your/their skills and strengths and whether they help or hinder in the proposed venture?

Create a one-page resume of each key person. This is not merely a job history, but a picture of each key person, showing pertinent strengths, skills, experience, training and qualifications. It will reveal to you and any potential lender, supplier, partners or agent, the operational/management strengths (and weaknesses) of you and your team. It will also show you the need to acquire any missing skills you can identify.

3. Personal Objectives

Why do you want to go into business? Answer - To create wealth!

Remember. business is principally a means of allowing people to achieve the things they want in their private life, like a home, cars, holidays and a good lifestyle. You need to set personal objectives. Do you know what you want in your private life? Consider Short Term - say up to one year; Medium Term - one to three years; Long term - greater than three years.

You need to sort out life objectives and ensure that the business will not only assist you in generating wealth but also facilitate your life style.

4. The Market

Customers- You cannot sell to everyone. So, who are your potential customers? Make a List. Why will they buy from you?

Identify your Market Segments or groups. What knowledge do you have of your market segments or groups? How many are there? What will they buy? How often will they buy? What will be their average purchase?

Products & Services- Create a list showing the products / services you will be offering to each segment. Also look at how long it will take you to produce or procure them. Determine how much it will cost to buy or produce them and how much you can sell them for. Suppliers. Identify preferred and alternative suppliers on a list and show products /services / prices on this list. Collect catalogues and brochures to assist this study.

Competition- List your competitors and show their perceived strengths and weaknesses. For each main competitor, list two good points and two bad points. You need to understand why they are competition to your proposed business. Ask the Question. How can you attract their customers from them? Price is not the only answer.

Map- Obtain a map and on it define your market boundaries, location, competitors, suppliers, and demographic information on your market.

5. Your Business Overview

Location - Your site, is it rented, owned, or at home? Why locate there? What are the advantages and disadvantages?

4.4.4 Function of A Feasibility Plan – Proof of Business Concept

Feasibility plans help entrepreneurs - and their investors - judge whether a business concept is credible. The process of preparing a feasibility plan is a testing process - a validation process to determine what could go wrong and what needs to go right for an enterprise to root and grow. Preparing a feasibility plan requires a tremendous amount of research and thinking, which often lead to significant changes in the original idea. The good news is that the stronger the feasibility plan the easier the business plan is to write and the more likely it is that your business will receive financial support and succeed.

Feasibility Plan Narrative

The feasibility plan is not a formal document but it can be considered a structured formal commercial report. It is your first reality check. (The marketplace will be the real check.) As such, the plan should be very carefully thought through, extraordinarily well

documented and clearly written. A feasibility study (proof of business concept) can exist in its own right or be in part of whole a supporting document (appendix) for the formal business plan. Within a formal business plan many decisions or business models will be used and the justification for those actions must be clearly demonstrated and this is often achieved by being able to reference to findings of the original business concept feasibility study

A feasibility plan should at least touch on most issues included in the final business plan. In the feasibility plan, the focus is on getting the design right and testing its coherence, rather than on convincing investors and other partners to extend their support. Often the feasibility study's validity is demonstrated through a cost benefit analysis. A cost - benefit analysis is a relatively simple and widely used technique for deciding whether a business model or decision is financially viable. As its name suggests, to use the technique simply add up the value of the benefits of a course of action, and subtract the costs associated with it.

Accordingly, clarity and factual evidence are more important for the feasibility plan than a convincing business presentation.

4.4.2 Cost Benefit Analysis

One of the main ways people make decisions is by using a cost benefit analysis (or CBA).

Whether you're a renter considering purchasing a new home or a business weighing a new sales strategy, you're probably using a CBA. It's an integral part of corporate, individual and even government decision making.

Even when big companies like Macy's (M) - Get Macy's Inc Report move to repurchase hundreds of millions of dollars of their own debt, executives are using CBA. In fact, most actions undertaken by companies involve CBA in some form or other.

But what actually is cost benefit analysis, and how is it used? What are some examples of cost benefit analysis?

What is cost benefit analysis. Cost benefit analysis is a process used primarily by businesses that weighs the sum of the benefits, such as financial gain, of an action against the negatives, or costs, of that action. The technique is often used when trying to decide a course of action, and often incorporates dollar amounts for intangible benefits as well as opportunity cost into its calculations.

Although CBA can be used for short-term decisions, it is most often used when a company or individual has a long-term decision.

CBA is an easy tool to determine which potential decision would make the most financial sense for the business or individual. The process also takes indirect benefits or costs into consideration, like customer satisfaction or even employee morale. And opportunity cost often plays a big role when deciding between several options. When listing potential costs and benefits, companies or analysts will often factor in things like labor costs, social benefits and other factors that may not be immediately obvious.

Still, CBA is similar to net present value (or NPV), which is often used by investors.

So, what's the difference between CBA and NPV?

Cost Benefit Analysis vs. Net Present Value

When performing a cost benefit analysis, or CBA, it is generally helpful to weigh the total benefits and total costs of a future project at their present value - which is where net present value comes in. Given that CBAs are often done with a long-term view in mind, the value of money often changes due to inflation and other factors, making it helpful to factor in the net present value of the figures you are analyzing when conducting a CBA.

Net present value, as the name suggests, is a method used to determine the benefits of undertaking an investment by calculating the future benefits or costs in terms of their present value. If the net present value is positive for the calculation (meaning the benefits outweigh the costs), the action or decision will generally be a good investment. If negative, the opposite is likely true.

In CBA, net present value is used to calculate net present costs and net present benefits.

How to calculate Cost Benefit Analysis

For standard CBA, the formula, the benefit/cost ratio, is fairly simple.

Benefit/cost, simplified as b/c .

Cost Benefit Analysis Steps

Cost benefit analysis is fairly simple to execute, and can be helpful when considering a new course of action or strategy.

Step 1. Compile lists

The first thing to do when running a cost benefit analysis is to compile a comprehensive list of all the costs and benefits associated with the potential action or decision.

Consider not only the obvious costs (like the cost of installation for new software, or for the software itself) but also possible intangible costs like the opportunity cost of picking one software over another, or over another option like hiring a new employee.

Additionally, consider all the possible benefits of the course of action or decision - how much might it add to your revenue? What other benefits may be inherent in the action that would make it outweigh the costs? For example, would a new software improve efficiency or capabilities that could promote new business or make current operations run smoother? Be sure to also consider intangible benefits as well as obvious, fiscal ones.

Step 2. Give the costs and benefits a monetary value

Once you have two comprehensive lists of costs and benefits for the action, assignment. For some, the values will be obvious - like the cost of installing the software might be \$500. However, it is also important to try to assign monetary values to direct or indirect and tangible and intangible costs or benefits if possible. For example, installing a new software may render an employee's computer inaccessible for a couple hours, costing that employee working time or productivity and therefore money generated for the company. Once you assign monetary values for each cost and benefit, add all the costs and benefits respectively and set up the equation.

For some, the values will be obvious - like the cost of installing the software might be \$500. However, it is also important to try to assign monetary values to direct or indirect and tangible and intangible costs or benefits if possible. For example, installing a new software may render an employee's computer inaccessible for a couple hours, costing that employee working time or productivity and therefore money generated for the company.

Once you assign monetary values for each cost and benefit, add all the costs and benefits respectively and set up the equation.

Step 3. Set up the equation and compare

Take the sum of the benefits (the sum of all the monetary values assigned to the benefits of the action) and the sum of the costs (all the monetary values of the costs of the action) and plug them into the b/c equation.

The equation should be a numerical equation, and if the numerical benefits (the sum of the fiscal values for the benefits of the action) outweigh the costs, it is advisable to proceed with the decision. If not, the company or individual should re-examine the potential action and make adjustments accordingly.

This equation can also be set up for multiple different options or projects and can help companies compare options side by side.



Activity 4.4

1. What do you mean by cost benefit analysis?
2. What is business plan?
3. What are the components of a business plan?



Self-test exercise 4.4

Dear distance learner, please define business plan. Also list its components. Did you try? Great job!



Suggested Answers

1. Business plan is a detailed plan of a new business.
2. Components of a business plan- please refer from the text book!

Check List

Dear distance learner, we hope you enjoyed working on this section. Now it is time to check your understanding about evolution of money. Read each question and put a tick (✓) mark in the 'yes' or 'no' box, which helps you decide on your level of understanding of the points presented so far.

Objectives	Yes	No
Can you define Innovation		
Can you describe Business Startups		
Can you discuss types of Businesses Organizations		
Can you discuss Business Feasibility Analysis		

Dear distance learner, did you mark any box under the 'No' column? If so, please look at the corresponding item to the left and go back to your text and read about it.



Unit Summary

Innovation can be defined as something new, improved or introduced that creates value. It can be summarized into two key elements. creativity and implementation.

Business Startups won't be profitable in the initial stages of business development since they want to grow within the shortest time possible. It will sometimes take years for a startup to make its first dollar of profit.

The main goal in business startups is to create a product or service that can be successfully placed on the market, which could bring in millions of dollars of profit in the long run. Among the most successful startups is *Uber*, which now has a market value of *\$50 billion*.

Business organizations may be owned and managed by a single individual or group of individuals who may form a partnership firm or a joint stock company. Such arrangement of ownership and management is termed as a form of business organization. A business organization usually takes the following forms. sole ownership, partnership business and Corporations.

Cost benefit analysis is a process used primarily by businesses that weighs the sum of the benefits, such as financial gain, of an action against the negatives, or costs, of that action. The technique is often used when trying to decide a course of action, and often incorporates dollar amounts for intangible benefits as well as opportunity cost into its calculations.



Unit Review Exercises

- I. **Write True if the Statement is correct or False if not correct for the following questions**
1. Development of a new product contribute to creative destruction
 2. Taking -over of a competitor contribute to creative destruction
 3. Issuing shares contribute to creative destruction
 4. Reducing prices contribute to creative destruction
 5. Ability to carry out R&D is an advantage of the small firm in the innovation process.
 6. Ability to raise finance is an advantage of the small firm in the innovation process.
 7. Ability of the entrepreneur to carry out multiple tasks is an advantage of the small firm in the innovation process.
 8. Ability of the entrepreneur to act on new ideas or product development is an advantage of the small firm in the innovation process.
 9. External links may provide incentives to Raise finance
 10. External links may provide incentives to Introduce new working practices
 11. External links may provide incentives to Introduce improvements to products
 12. External links may provide incentives to Attend business exhibitions
 13. Firms located on science parks compared to those located off science parks are More innovative
 14. Schumpeter considered that innovative entrepreneurs would disappear
 15. Innovative entrepreneurs may have to pay high insurance premiums due to the need to protect patents
- II. **Multiple choice questions. choose the best answer for the following questions**
1. Innovation is _____
A . only creating new things
B . creating news process
C . only creating new process
D . none
 2. Business startups _____
A . can bring quick profits in the short run
B . cannot bring quick profits in the short run
C . can bring profits in the long run
D . cannot bring quick profits in the long run
 3. Sole ownership businesses are _____
A . owned and managed by one individual
B . owned and managed by more than two individuals
C . owned and managed by three individuals
D . corporations
 4. Cost benefit analysis (CBA) is _____
A . a tool to check the profitability of a business or startups.
B . a tool to check the sustainability of a business or startups.
C . a tool to check the market situation of a business or startups.
D . None of the above



Answers to Activities

The following are possible answers to the activities in unit Four.

Activity 4.1

- Innovation is creation of new products, or new production process.
- BPR is a process innovation, KAIZEN is a process innovation, DRONE is a product innovation, etc.

Activity 4.2

- Startup businesses are new businesses coming as new based on innovations.
- Small businesses do not necessarily need innovation like startups.

Activity 4.3

1. Sole ownership business, Partnership business, and Corporations.
2. Any small shops – Sole ownership; any medium sized two/three owners owned businesses- Partnership; Banks, insurance companies, etc. are Corporations.

Activity 4.4

1. Business plan is a detailed plan of a new business.
2. Components of a business plan- please refer from the text book!



Answer for Review Exercises

I True/False

1. False
2. True
3. False
4. False
5. False
6. False
7. False
8. True
9. True
10. True
11. True
12. True
13. True
14. False
15. True

II. Multiple choice questions

1. B
2. C
3. A
4. A

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Glossary

Agricultural sector (noun): the sector of an economy formed by agriculture, forestry and fishing

Autonomous consumption, autonomous expenditure (noun): national consumption expenditure which does not vary with national income, but which represents expenditure which is necessary to maintain a basic standard of living even when personal incomes are zero. It is not related to the GDP, but can have an effect on the economy.

Autonomous investment (noun): investment which is not related to increases or decreases in national income or in output, but which may be due to factors such as changes in government policy or the response to new inventions

Backward integration (noun): a situation in which a company joins with another which is at an earlier stage in the production or distribution line, as when a supermarket purchases a milk company. Also called vertical integration (NOTE: The opposite is forward integration.)

Bank (noun): a business which holds money for its clients, which lends money at interest, and trades generally in money. Banks are licensed by the regulatory authorities such as the National Bank of Ethiopia or, in the USA, the Federal Reserve. (Verb): to put or keep money in a bank

Bank account (noun): an arrangement that a customer has with a bank, where the customer can deposit and withdraw money (NOTE: The US term is banking account.)

Bank loan (noun): a loan made by a bank to a customer, usually against the security of a property or asset. Also called bank advance

Black market (noun): the buying and selling goods or currency in a way which is not allowed by law, as when a government imposes price controls or rationing. The prices on a black market are always higher than regular prices.

Boom (noun): a time when sales or production or business activities are increasing (verb): to increase in volume or activity

Business cycle (noun): a period during which trade (GDP) expands, then slows down, then expands again. Also called trade cycle

Capital market (noun): a financial market dealing in bonds and other financial instruments used by companies to get funds. It is the place where companies can look for long-term investment capital.

Consumer expenditure (noun): private spending by consumers on services, durables and non-durables; it is one of the elements that makes up 'aggregate expenditure.' consumption expenditure

Consumer non-durables (plural noun): goods purchased by consumers which are used

up immediately and have to be replaced, such as food and drink, gas, electricity, etc

Consumer Price Index (noun): a US index showing how prices of consumer goods have risen over a period of time. Abbreviation CPI (NOTE: The UK term is retail prices index.)

Consumption (noun): the purchasing of goods or services to satisfy needs, in particular in the household sector

Consumption expenditure (noun): the expenditure made by the household sector on durables, non-durables and services, shown as a proportion of national income

Corporation (noun): a large limited liability company; especially a limited liability company which is incorporated in the USA. incorporation

Creative destruction (noun): the theory of Joseph Schumpeter that economic growth is caused by entrepreneurs who take risks and destroy previous business practices by their innovations. He believed that this was the essential force of capitalism.

Default (noun): a failure to carry out the terms of a contract, especially failure to pay back a debt (verb): to fail to carry out the terms of a contract, especially to pay back a debt

Deposit account (noun): an account which pays interest, but on which notice usually has to be given to withdraw money. Also called time account

Depression (noun): a period of economic crisis with high unemployment and loss of trade

Developed country (noun): a country which has fully developed industrial sectors and service sectors, with a high per capita GNP

Diffusion of innovations (noun): the process by which innovations become accepted by firms or individual consumers, either at home or internationally

Economic development (noun): the expansion of the commercial and financial situation in developing countries by industrialization

Economic growth (noun): the rate at which a country's national income grows, usually shown as an increase in GDP or GNP or an increase in per capita income

Export (noun): 1. a product which is sold and transported to a foreign country. Exports (noun): 2. The practice or business of sending goods to foreign countries to be sold (verb): to sell and transport a product to a foreign country

Export incentive (noun): a way of encouraging exports, e.g. guaranteeing credit, subsidies for exported goods or special tax concessions so that exporters pay lower tax on profits from exports

Factor of production (noun): one of the four things needed to produce a product (land,

labour, machinery and capital)

Finance (noun): 1. money available for investment, as a loan or for a similar use 2. The business of managing money (verb): to provide money for an investment, as a loan or for a similar use

Financial assets (plural noun): assets in the form of liquid money or certificates which can be liquidated (such as government stocks, share certificates or fixed-interest bonds)

Financial innovation (noun): a new idea introduced into the financial world which gradually becomes accepted, such as automatic bank transfers or swipe cards

Financial intermediary (noun): an institution which takes deposits or loans from individuals and lends money to clients. Banks, building societies and hire purchase companies are all types of financial intermediary.

Forward integration (noun): a situation in which a company joins with another which is at a later stage in the production or distribution line, as when a milk company acquires an ice cream company. Compare backward integration

GDP deflator (noun): the amount by which a country's GDP is reduced to take inflation into account. Also called gross domestic product deflator

Government expenditure (noun): spending by a government, municipality or local authority. It covers things such as spending on health, education and social services, and is funded by tax revenue. It is one of the elements that make up aggregate expenditure. Also called government spending

Gross domestic product (noun): the annual value of goods sold and services paid for inside a country. Abbreviation GDP

Group Lending: Lending mechanism, which allows a group of individuals - often called a solidarity group - to provide collateral or loan guarantee through a group repayment pledge. The incentive to repay the loan is based on peer pressure - if one group member defaults, the other group members make up the payment amount.

Import (noun): a product which is bought and brought in from a foreign country. Imports (verb): to bring goods from abroad into a country for sale

Industrial policy (noun): a government's policy relating to industry

Industrial production (noun): production by manufacturing industries, as opposed to service industries or agriculture

Industrial sector (noun): the sector of the economy dealing with industry which produces goods. Also called secondary sector

Industry (noun): all factories, companies or processes involved in the manufacturing of products

Inflation (noun): a situation in which prices rise to keep up with increased production costs, with the result that the purchasing power of money falls

Innovation (noun): the act of developing something new, such as new form of product or service, which allows a firm to maintain a market position in advance of its rivals. It is the application of an invention to the commercial world.

Invention (noun): 1. a new product or process 2. the creation of new products or processes which are then developed for commercial use through innovation

Investment (noun): the placing of money so that it will increase in value and produce an income (either in an asset, such as a building, or by purchasing shares, placing money on deposits, etc.)

Least developed countries (plural noun): the 49 poorest countries as defined by the United Nations. They are countries which have very low per capita GDP and low human assets and are perceived as economically vulnerable. Abbreviation LDCs

Microcredit: Another name for a micro-loan. A part of the field of microfinance, microcredit is the provision of credit services to low-income entrepreneurs.

Microfinance Institution (MFI): A financial institution that provides microfinance products and services to the world's poor. It can be a nonprofit organization, regulated financial institution or commercial bank and is often not licensed in the same way as banks, so in some cases they cannot legally take deposits or handle many financial transactions.

Microfinance: The practice of providing financial services in very small increments to the working poor.

Money market (noun): the market for buying and selling short-term loans or financial instruments such as Treasury bills and CDs, which can be easily converted to cash

National income accounts (plural noun): national accounts showing the value of goods and services produced and sold both domestically and exported over a period of one year. They cover both GDP and GNP, together with other income from investments abroad.

Non-marketed economic activities (plural noun): activities which are not sold through a market and so not declared as part of the national income, such as unpaid charity work or the provision of services free to pensioners or the role of housewives in developing countries.

Partnership (noun): an unregistered business where two or more people (but not more than twenty) share the risks and profits according to a partnership agreement

Partnership agreement (noun): a document which sets up a partnership, states what it is called, what the capital is, how much is contributed by each partner, the rights of each partner, profit-sharing ratios and the way the partnership may be dissolved in

due course. Also called articles of partnership

Per capita income (noun): the total national income divided by the number of population. It can be calculated more accurately by giving more weight to adults. Also called income per capita, income per head

Per capita real GDP (noun): GDP calculated per adult member of the population. It is lower than per capita income when the country's income includes important revenue from investments abroad.

Population (noun): the number of people who live in a country or in a town

Population trap (noun): a situation in which a country's economy cannot grow because its population is rising so fast that general poverty increases. The only solution is to reduce the increase in population by birth control.

Product innovation (noun): the production of a totally new product, rather than a new production process

Real GDP (noun): GDP which has been adjusted for inflation

Real GNP (noun): GNP which has been adjusted for inflation

Recession (noun): a fall in trade or in the economy of a country. There are various ways of deciding if a recession is taking place: the usual one is when the GNP falls for two consecutive quarters.

Savings (plural noun): money saved (i.e. not spent), including money in savings accounts and also money invested in securities

Savings account (noun): a bank account where you can put money in regularly and which pays interest, often at a higher rate than a deposit account

Service industry (noun): an industry which does not produce raw materials or manufacture products but offers a service (such as banking, retailing or accountancy)

Service sector (noun): the service industries taken as a whole

Services (plural noun): 1. the business of providing help in some form when it is needed (activities such as insurance or banking as opposed to the making or selling of goods) 2. systems which provide members of the public with what they need, such as transport or hospitals

Sole proprietor, sole trader (noun): a person who runs a business by himself or herself but has not registered it as a company

Technological progress (noun): advances in techniques which lead to improved market share. Such techniques can be new machinery or improved education of workers.

Unemployment (noun): a situation in which people have no jobs

Unemployment benefit (noun): payment made to someone who is unemployed in developed countries (NOTE: The US term is unemployment compensation.)

Unemployment rate (noun): the number of people out of work, shown as a percentage of the total number of people available for work. Also called rate of unemployment

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