Economics Short Notes

**Inferior Good**
An inferior good is a good that decreases in demand when consumer income rises (or rises in demand when consumer income decreases). The demand for inferior goods goes down as income increases. Consumers of inferior goods "trade up" to higher priced goods as soon as they can afford it. Transportation provides a good example. When income is low, it makes sense to ride the bus. But as income increases, people stop riding the bus and start buying cars. It's acceptable to most people to ride the bus when they can't afford a car. But as soon as they can afford one, they buy a car and stop riding the bus. Bus riding declines as income increases. Rice, potatoes and instant noodles are other examples of inferior goods.

Inferior goods are not the same worldwide. Fast food can be considered an inferior good in many western countries, while emerging economies consider it a normal good as they trade up from rice, potatoes, etc.

**Giffen Good**
A Giffen good is a good for which demand increases as the price increases, and falls when the price decreases - violating the law of demand. A Giffen good is typically an inferior product that does not have easily available substitutes, as a result of which the income effect dominates the substitution effect.

Suppose you have a very low income and eat two basic food stuffs rice and meat. Meat is a luxury and is much more expensive than rice. If rice increased in price, your disposable income is effectively reduced significantly therefore, you buy less meat, to compensate for less meat you buy more rice to gain enough calories.

**Substitute Goods**
Substitute goods or substitutes are products that a consumer perceives as similar or comparable, so that having more of one product makes them desire less of the other product. Formally, X and Y are substitutes if, when the price of X rises, the demand for Y rises. For example, a car and a bicycle may substitute to some extent: if the price of motor fuel increases considerably, one may expect that some people will switch to bicycles.

**Variable Costs and Fixed Costs**
Fixed costs are costs that are independent of output. These remain constant throughout the relevant range and are usually considered sunk for the relevant range (not relevant to output decisions). Fixed costs often include rent, buildings, machinery, etc.

Variable costs are costs that vary with output. Generally variable costs increase at a constant rate relative to labor and capital. Variable costs may include wages, utilities, materials used in production, etc. Another example could be electricity--electricity usage may increase with production but if nothing is produced a factory still may require a certain amount of power just to maintain itself.

For example, if a telephone company charges a per-minute rate, then that would be a variable cost. A twenty minute phone call would cost more than a ten minute phone call. A good example of a fixed cost is rent. If a company rents a warehouse, it must pay rent for the warehouse whether it is full of inventory or completely vacant.

**Return to Scale**
The term return to scale refers to the changes in output as all factors change by the same proportion. If output increases by that same proportional change as all inputs change then there are constant returns to scale (CRS). If output increases by less than that proportional change in inputs, there are decreasing returns to scale (DRS). If output increases by more than that proportional change in inputs, there are increasing returns to scale (IRS).

In the long run all factors of production are variable and subject to change due to a given increase in size (scale). While economies of scale show the effect of an increased output level on unit costs, returns to scale focus only on the relation between input and output quantities.
Repo, Reverse Repo

A repo or repurchase agreement: is an instrument of money market. Repo is a collateralized lending i.e. the commercial banks which borrow money from central bank by selling securities to meet short term needs with an agreement to repurchase the same at a predetermined rate and date. The central bank charges some interest rate on the cash borrowed by banks, but this rate (called repo rate) will be less than the interest rate on bonds.

Reverse repo: In a reverse repo central bank borrows money from commercial banks by lending securities. The interest paid by central bank in this case is called reverse repo rate.

Public Good

A public good is a product that one individual can consume without reducing its availability to another individual, and from which no one is excluded. It is a commodity or service that is provided without profit to all members of a society, either by the government or a private individual or organization.

A public good is defined as an economic good which possesses two properties: non-rivalrous and non-excludable. Some examples of public goods include clean air, national defense, the judiciary, lighthouses, street lights, and the well known example of a fireworks show.

CRR & SLR

Cash Reserve Ratio (CRR) is a specified minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves either in cash or as deposits with the central bank. CRR is set according to the guidelines of the central bank of a country.

Statutory liquidity ratio (SLR) is the Bangladesh Bank reserve requirement that the commercial banks in Bangladesh require to maintain in the form of gold, government approved securities before providing credit to the customers.

Opportunity Cost

An opportunity cost is the cost of an alternative that must be forgone in order to pursue a certain action. In microeconomic theory, the opportunity cost of a choice is the value of the best alternative forgone where, given limited resources, a choice needs to be made between several mutually exclusive alternatives. Basically it is the costs of forgoing next best alternative.

Disguised Unemployment

Disguised unemployment exists where part of the labor force is either left without work or is working in a redundant manner where worker productivity is essentially zero. It is unemployment that does not affect aggregate output. When more people are engaged in some activity than the number of person required for that, this is called disguised unemployment. For example: An agricultural field require 4 labourers but people engaged in this activity is 6 then this unemployment for 2 labours is called disguised unemployment.

Green Banking

Green banking is like a normal banking, which considers all the social and environmental/ecological factors with an aim to protect the environment and conserve natural resources. It is also called as an ethical bank or a sustainable bank. They are controlled by the same authorities but with an additional agenda toward taking care of the Earth's environment/habitats/resources. Green Banking means paper less or paper reduce banking like Mobile banking, i-banking, Card etc.

Reserve Money

Reserve money is defined as the portion of the commercial banks' reserves that are maintained in accounts with their central bank plus the total currency circulating in the public (which includes the currency, also known as vault cash, that is physically held in the banks' vault).

Money Multiplier

The money multiplier is the amount of money that banks generate with each dollar of reserves. It represents the maximum extent to which the money supply is affected by any change in the amount of deposits. It equals ratio of increase or decrease in money supply to the corresponding increase and decrease in deposits. Thus, it can be said Money multiplier shows the mechanism by which reserve money creates money supply in the economy.

The money multiplier effect arises due to the phenomenon of credit creation. When a commercial bank receives an amount A, its total reserves are increased. The bank is required by the central bank to hold only an amount equal to $r \times A$ in hand to meet the demand for withdrawals, where $r$ is the required reserve ratio. The bank is allowed to extend the excess reserves i.e. $(A - r \times A)$ as loans. When the borrower keeps the whole amount of loan in bank (it is assumed), it
increases its total reserves by an amount equal to \((A - r \times A)\). Again, the bank is required to hold only a fraction of this second round of deposits and it can lend out the rest. This cycle continues such the ultimate increase in money supply due to an initial increase in checking deposits of amount \(A\) is equal to \(m \times A\), where \(m\) is the money multiplier. The opposite happens in case of a decrease in deposits through the same mechanism.

\[
\text{Money Multiplier} = \frac{1}{\text{Required Reserve Ratio}}
\]

**Income Velocity of Money**

In economics, thenumber of timesone unit of currency is spent over a given period of time. It is indicative of howmucheconomic activityoccurs or is possible at a certain level of money supply. The income velocity of money tends to rise and fall concurrently with interest rates. It is calculated thus:

\[
\text{Income velocity of money} = \frac{\text{GDP}}{\text{money supply (however defined)}}
\]

**Cost push inflation**

Cost push inflation is inflation caused by an increase in prices of inputs like labour, raw material, etc. The increased price of the factors of production leads to a decreased supply of these goods. While the demand remains constant, the prices of commodities increase causing a rise in the overall price level.

This is inflation triggered from supply side i.e. because of less supply. The opposite effect of this is called demand pull inflation where higher demand triggers inflation.

**Positive & Normative economics**

Positive economics is objective and fact based, while normative economics is subjective and value based. Positive economic statements do not have to be correct, but they must be able to be tested and proved or disproved. Normative economic statements are opinion based, so they cannot be proved or disproved.

For example, the statement, "government should provide basic healthcare to all citizens" is a normative economic statement. There is no way to prove whether government "should" provide healthcare; this statement is based on opinions about the role of government in individuals' lives, the importance of healthcare and who should pay for it.

The statement, "government-provided healthcare increases public expenditures" is a positive economic statement, because it can be proved or disproved by examining healthcare spending data in countries like Canada and Britain where the government provides healthcare.

**CAMELS Rating System**

The CAMELS rating system is an international bank-rating system where bank supervisory authorities rate institutions according to six factors.

The six factors are represented by the acronym "CAMELS."

The six factors examined are as follows:

- C - Capital adequacy
- A - Asset quality
- M - Management quality
- E - Earnings
- L - Liquidity
- S - Sensitivity to Market Risk

Bank supervisory authorities assign each bank a score on a scale of one (best) to five (worst) for each factor. If a bank has an average score less than two it is considered to be a high-quality institution, while banks with scores greater than three are considered to be less-than-satisfactory establishments. The system helps the supervisory authority identify banks that are in need of attention.

**Financial Inclusion or Inclusive Financing**

Financial inclusion or inclusive financing is the delivery of financial services at affordable costs to sections of disadvantaged and low-income segments of society, in contrast to financial exclusion where those services are not available or affordable. It is argued that as banking services are in the nature of a public good, the availability of banking and payment services to the entire population without discrimination is a key objective of financial inclusion.
Asian Clearing Union (ACU)

Asian Clearing Union (ACU) is a payment arrangement whereby the participants settle payments for intra-regional transactions among the participating central banks on a net multilateral basis. The main objectives of the clearing union are to facilitate payments among member countries for eligible transactions, thereby economizing on the use of foreign exchange reserves and transfer costs, as well as promoting trade and banking relations among the participating countries.

The Central Banks and the Monetary Authorities of Bangladesh, Bhutan, India, Iran, Maldives, Myanmar, Nepal, Pakistan and Sri Lanka are currently the members of the ACU.

The Asian Clearing Union (ACU) was established with its headquarters at Tehran, Iran, on December 9, 1974 at the initiative of the United Nations Economic and Social Commission for Asia and Pacific (ESCAP), for promoting regional co-operation.

Fiscal Policy

Fiscal policy is the means by which a government adjusts its spending levels and tax rates to monitor and influence a nation's economy. It is the sister strategy to monetary policy through which a central bank influences a nation's money supply. These two policies are used in various combinations to direct a country's economic goals.

Governments can influence macroeconomic productivity levels by increasing or decreasing tax levels and public spending. This influence, in turn, curbs inflation (generally considered to be healthy when between 2-3%), increases employment and maintains a healthy value of money. Fiscal policy is very important to the economy.

Index Number

An index is a statistical measure of changes in a representative group of individual data points. These data may be derived from any number of sources, including company performance, prices, productivity, and employment. Economic indices track economic health from different perspectives. It is a number indicating change in magnitude, as of price, wage, employment, or production shifts, relative to the magnitude at a specified point usually taken as 100.

The primary role of index numbers is to simplify otherwise complicated comparisons. It is especially useful when comparing currencies that have lots of different nominal values. Some countries even use index numbers to modify public policy, such as adjusting government benefits for inflation.

Currency Depreciation

Currency depreciation is a decrease in the level of a currency in a floating exchange rate system due to market forces. Currency depreciation can occur due to any number of reasons – economic fundamentals, interest rate differentials, political instability, risk aversion among investors and so on. Countries with weak economic fundamentals such as chronic current account deficits and high rates of inflation generally have depreciating currencies. Currency depreciation, if orderly and gradual, improves a nation’s export competitiveness and may improve its trade deficit over time. But abrupt and sizeable currency depreciation may scare foreign investors who fear the currency may fall further, and lead to them pulling portfolio investments out of the country, putting further downward pressure on the currency.

Terms of Trade - TOT

Terms of trade (TOT) is the value of a country's exports relative to that of its imports. It is calculated by dividing the value of exports by the value of imports, then multiplying the result by 100. If a country's terms of trade (TOT) is less than 100%, there is more capital going out (to buy imports) than there is coming in. A result greater than 100% means the country is accumulating capital (more money is coming in from exports).

Using the terms of trade to determine the health of a country's economy can draw the wrong conclusions. It is important to know why exports increase relative to imports, especially since the terms of trade are directly impacted by changes in export and import prices. Terms of trade measurement is often recorded in an index for economic monitoring.

For example, if, over a given period, the index of export prices rises by 10% and the index of import prices rises by 5%, the terms of trade are:
110 \times 100 / 105 = 104.8 \\
This means that the terms of trade have improved by 4.8%. \\
When the terms of trade rise above 100 they are said to be improving and when they fall below 100 they are said to be worsening.

**Floating Exchange Rate**

A floating exchange rate is a regime where the currency price is set by the forex market based on supply and demand compared with other currencies. A currency that uses a floating exchange rate is known as a floating currency. The currencies of most of the world's major economies were allowed to float freely following the collapse of the Bretton Woods system in 1971.

In floating exchange rate systems, central banks buy or sell their local currencies to adjust the exchange rate; this can be aimed at stabilizing a volatile market or achieving a major change in the rate. Groups of central banks, such as those of the G-7 nations (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States), often work together in coordinated interventions to increase the impact.

**Fixed Exchange Rate**

A fixed exchange rate is a country's exchange rate regime under which the government or central bank ties the official exchange rate to another country's currency (or the price of gold). The purpose of a fixed exchange rate system is to maintain a country's currency value within a very narrow band. Also known as pegged exchange rate.

Fixed rates provide greater certainty for exporters and importers. This also helps the government maintain low inflation, which in the long run should keep interest rates down and stimulate increased trade and investment.

**The Vicious Cycle of Poverty**

This is a phenomenon used often by economic scientists. It simply means poverty begets poverty. It is a concept that illustrates how poverty causes poverty and traps people in poverty unless an external intervention is applied to break the cycle.

Let's look at this scenario with a family in absolute poverty.

![Diagram of the Vicious Cycle of Poverty]

A very poor family with children have very little to eat, and have and access to health facilities. As a result, the children are malnourished and unhealthy and have many health complications. They are therefore unable to go to school (even if there is a school in the next village). They grow up with no education or skill and cannot do any economic activity. Their parent die from preventable diseases as a result of lack of health facilities, and their fate is in their hands. As the children turn adults, they find wives who are just on the same level of poverty as them, and they have their own children. They hand over this condition to their children, who will also grow up in similar conditions.

It takes an intervention from governments, charity organizations or family members who are better off to step in and provide some kind of assistance (health, feeding, shelter and basic education) to get the youth to do some kind of...
economic activity to bring in some income. Without that, this cycle will continue for generations and it’s a trap that is extremely difficult to get out of.

**Basel**

Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision.

Basel II, initially published in June 2004, was intended to amend international standards that controlled how much capital banks need to hold to guard against the financial and operational risks banks face. These rules sought to ensure that the greater the risk to which a bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and economic stability. Basel II attempted to accomplish this by establishing risk and capital management requirements to ensure that a bank has adequate capital for the risk the bank exposes itself to through its lending, investment and trading activities. One focus was to maintain sufficient consistency of regulations so to limit competitive inequality amongst internationally active banks.

Basel II uses a "three pillars" concept – (1) minimum capital requirements (addressing risk), (2) supervisory review and (3) market discipline.

The Basel I accord dealt with only parts of each of these pillars. For example: with respect to the first Basel II pillar, only one risk, credit risk, was dealt with in a simple manner while market risk was an afterthought; operational risk was not dealt with at all.

**Minimum capital requirements:** The first pillar deals with maintenance of regulatory capital calculated for three major components of risk that a bank faces: credit risk, operational risk, and market risk.

**Supervisory review:** This is a regulatory response to the first pillar, giving regulators better 'tools' over those previously available. It also provides a framework for dealing with systemic risk, pension risk, concentration risk, strategic risk, reputational risk, liquidity risk and legal risk, which the accord combines under the title of residual risk. Banks can review their risk management system.

**The Market Discipline:** This pillar aims to complement the minimum capital requirements and supervisory review process by developing a set of disclosure requirements which will allow the market participants to gauge the capital adequacy of an institution.

Basel III, The third installment of the Basel Accords, was developed in response to the deficiencies in financial regulation revealed by the financial crisis of 2007–08. Basel III is intended to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage.
**Producer Surplus**

Producer surplus is an economic measure of the difference between the amount that a producer of a good receives and the minimum amount that he or she would be willing to accept for the good. The difference, or surplus amount, is the benefit that the producer receives for selling the good in the market.

Q. Identify the basic characteristics of monopoly, oligopoly, monopolistic competition, and perfect/pure competition.

**Monopoly**
- One firm
- Complete barrier to entry
- Total control over price
- One product

According to Professor Brenham, “The monopoly can fix whatever price he pleases or can sell whatever amount he planes but he cannot sell as much likes whatever price he likes.” According to Economist Stigler, “Monopoly is such a firm producing a commodity of which there are no clause substitutes.”

**Oligopoly:**
- 2-3 firms
- High barrier to entry
- Control majority of output
- Similar/identical products

**Monopolistic Competition**
- Many Firms
- Few artificial barriers to entry
- Slight control over price
- Differentiated products

**Perfect (Pure) Competition**
- Many Buyers and Sellers
- Identical Products
- Informed Buyers and Sellers
- Free Market Entry and Exit

**Excess Liquidity**

Excess liquidity is the liquidity that banks hold in excess of the aggregate needs arising from minimum reserve requirements and autonomous factors amount.

Excess liquidity is defined as deposits at the deposit facility net of the recourse to the marginal lending facility, plus current account holdings in excess of those contributing to the minimum reserve requirements.
In normal times, when the interbank market functions properly, banks would channel liquidity to each other across the system and excess liquidity would have little or no reason to exist, because the cost opportunity of holding it would be just too high.

**Gresham's law**

Gresham's law is an economic principle that states: "When a government overvalues one type of money and undervalues another, the undervalued money will leave the country or disappear from circulation into hoards, while the overvalued money will flood into circulation."

In economics, Gresham's law is a monetary principle stating that "bad money drives out good". For example, if there are two forms of commodity money in circulation, which are accepted by law as having similar face value, the more valuable commodity will disappear from circulation.

**Cross Elasticity of Demand**

Cross elasticity of demand is an economic concept that measures the responsiveness in the quantity demanded of one good when a change in price takes place in another good. The measure is calculated by taking the percentage change in the quantity demanded of one good, divided by the percentage change in price of the substitute good:

The cross elasticity of demand for substitute goods will always be positive, because the demand for one good will increase if the price for the other good increases. For example, if the price of coffee increases (but everything else stays the same), the quantity demanded for tea (a substitute beverage) will increase as consumers switch to an alternative.

On the other hand, the coefficient for compliments will be negative. For example, if the price of coffee increases (but everything else stays the same), the quantity demanded for coffee stir sticks will drop as consumers will purchase fewer sticks. If the coefficient is 0, then the two goods are not related.

**Price Elasticity Of Demand**

Price elasticity of demand is a measure of the relationship between a change in the quantity demanded of a particular good and a change in its price. Price elasticity of demand is a term in economics often used when discussing price sensitivity. The formula for calculating price elasticity of demand is:

Price Elasticity of Demand = % Change in Quantity Demanded / % Change in Price

If a small change in price is accompanied by a large change in quantity demanded, the product is said to be elastic (or responsive to price changes). Conversely, a product is inelastic if a large change in price is accompanied by a small amount of change in quantity demanded.

For example, if the quantity demanded for a good increases 15% in response to a 10% decrease in price, the price elasticity of demand would be 15% / 10% = 1.5. The degree to which the quantity demanded for a good changes in response to a change in price can be influenced by a number of factors. Factors include the number of close substitutes (demand is more elastic if there are close substitutes) and whether the good is a necessity or luxury (necessities tend to have inelastic demand while luxuries are more elastic).

Businesses evaluate price elasticity of demand for various products to help predict the impact of a pricing on product sales. Typically, businesses charge higher prices if demand for the product is price inelastic.

**Income Elasticity of Demand**

The income elasticity of demand is a measure of the relationship between a change in the quantity demanded for a particular good and a change in real income. Income elasticity of demand is an economics term that refers to the sensitivity of the quantity demanded for a certain product in response to a change in consumer incomes. The formula for calculating income elasticity of demand is:

Income Elasticity of Demand = % change in quantity demanded / % change in income

For example, if the quantity demanded for a good increases for 15% in response to a 10%increase in income, the income elasticity of demand would be 15% / 10% = 1.5. The degree to which the quantity demanded for a good changes in response to a change in income depends on whether the good is a necessity or a luxury.