



CA INTER

Important Questions for

ECONOMICS



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(MUST DO 50 QUESTIONS FOR CA INTER ECONOMICS)

by

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Question 1

Explain the following in context of national income.

- Economic Activities
- Current Year Production

Answer

*Economic
Activities
Only*

- ✓ National Income takes into account only the Economic Activities i.e. all human activities which create goods and services that are exchanged in a market and valued at market price.
- ✓ Non-economic activities also produce goods and services, but since these are not exchanged in a market transaction they do not command any market value; for e.g. hobbies, housekeeping and child rearing services of home makers and services of family members that are done out of love and affection.

*Current Year
Production*

- ✓ National Income includes only those goods and services, which are produced in the current period.
- ✓ Exchange of goods which are previously produced, do not enter into the calculation of national income as these don't fall under current production.
- ✓ However, the value of services that accompany the sale and purchase (e.g. fees paid to real estate agents and lawyers) represent current production and, therefore, is included in national income.

Question 2

Explain GDP_{MP}.

Answer

- ✓ It stands for Gross Domestic Product at Market Prices.
- ✓ It is a measure of the market value of all final economic goods and services, gross of depreciation, produced within the domestic territory of a country during a given time period. or
- ✓ It is the sum total of 'value added' by all producing units in the domestic territory and includes value added by current production by foreign residents or foreign-owned firms.
- ✓ 'Gross' implies that GDP is measured including depreciation.
- ✓ 'Domestic' means domestic territory.
- ✓ 'Market Price' means including Net Indirect Taxes.

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Question 3

Distinguish between Private Final Consumption Expenditure (PFCE) and Government Final Consumption Expenditure (GFCE).

Answer

Private Final Consumption Expenditure (PFCE)

- ✓ This takes into account the expenditure done by consumer households and non-profit institutions, on consumption.
- ✓ It includes :
 - ❖ Value of final sales of goods and services at market prices
 - ❖ value of primary products which are produced for own consumption by the households
 - ❖ payments for domestic services which one household renders to another,
 - ❖ the net expenditure on foreign financial assets or net foreign investment
- ✓ It excludes Land and residential buildings purchased or constructed by households as these are included in gross capital formation.

Government Final Consumption Expenditure (GFCE)

- ✓ It takes into account the collective services provided by the governments such as defence, education, healthcare etc.
- ✓ As these services are not sold in the market, the only way they can be valued in money terms is by adding up the money spent by the government in the production of these services.
- ✓ This total expenditure is treated as consumption expenditure of the government.
- ✓ However, the government expenditure on pensions, scholarships, unemployment allowance etc. should be excluded because these are transfer payments.

Question 4

Explain concept of Aggregate Demand.

Answer

Meaning

- ✓ Aggregate demand broadly refers to the total demand for final goods and services in the economy.
- ✓ It is expressed in terms of total expenditure.

Components

- ✓ Aggregate demand for consumer goods (C), and
- ✓ Aggregate demand for investment goods (I)

Formula

$$AD = C + I$$

Important Component

- ✓ Of the two components, consumption expenditure accounts for the highest proportion of the GDP.
- ✓ In a simple economy, the variable I is assumed to be determined exogenously and constant in the short run.
- ✓ Therefore, the short-run aggregate demand function can be written as:

$$AD = C + \bar{I}$$

Where $I = \text{constant investment}$

In the short run, AD depends largely on the aggregate consumption expenditure.

Question 5

What is the relevance of Saving Function?

Answer

Meaning

- ✓ Saving function shows the mathematical relation between income and saving i.e. how much of income is saved.

Peculiar Features

- ✓ At zero or very low level of income, Savings can be negative and
- ✓ As income increases, savings also increases but increase in savings is more than the increase in income.
- ✓ Level of savings depends directly on the level of income. Thus, savings (S) is a function (f) of income. So, $S = f(Y)$
- ✓ Saving is residual income of households that is left after consumption. Thus, $S = Y - C$.

Question 6

What is Investment Multiplier? How is it related to MPC & MPS?

Answer

Meaning

- ✓ Investment Multiplier (K), is the ratio of increase in national income (Y) due to an increase in investment (I).
- ✓ It expresses the relationship between an initial increment in investment and the resulting increase in aggregate income.
- ✓ Multiplier explains how many times the aggregate income increases as a result of an increase in investment.
- ✓ When the level of investment increases by an amount say ΔI , the equilibrium level of income will increase by some multiple amounts, ΔY .

Relationship of Multiplier with MPC & MPS

$$\frac{\Delta Y}{\Delta I} = \frac{1}{1-MPC} = \frac{1}{MPS}$$

- ✓ There exists a direct relationship between MPC and the value of multiplier.
- ✓ Higher the MPC, more will be the value of the multiplier, and vice-versa.
- ✓ On the contrary, higher the MPS, lower will be the value of multiplier and vice-versa.
- ✓ The maximum value of multiplier is infinity when the value of MPC is 1 i.e. the economy decides to consume the whole of its additional income.
- ✓ We conclude that the value of the multiplier is the reciprocal of MPS.

Question 7

What is the relevance of Government in 3 Sector Model?

Answer

3 Sector Model	<ul style="list-style-type: none"> ✓ Household sector ✓ Business sector ✓ Government Sector
Role of Government Sector	<ul style="list-style-type: none"> ✓ The three-sector model accounts for <u>government intervention</u> and highlights the role played by the government sector. ✓ The government sector adds the following key flows to the model : <ul style="list-style-type: none"> ❖ <u>Taxes</u> on households and business sector to fund government purchases. ❖ <u>Transfer payments</u> to household sector and <u>subsidy</u> payments to the business sector. ❖ Government <u>purchases goods and services</u> from business sector and <u>factors of production</u> from household sector, and ❖ <u>Government borrowing</u> in financial markets to finance the deficits occurring when taxes fall short of government purchases.

Question 8

What are different types of economic systems?

Answer

Types of Economic System	Market	✓ Decisions by market forces of demand and supply <u>without any government intervention.</u>
	Government	✓ Decisions unilaterally by the government <u>without any involvement of market.</u>
	Mixed system	✓ Where both <u>markets and governments simultaneously determine resource allocation.</u>

Question 9

What is market failure? Enumerate the reasons also.

Answer

Meaning	✓ Market failure occurs when the free market leads to misallocation of resources i.e. the <u>resources are not allocated efficiently.</u>
Reasons	<ul style="list-style-type: none"> ✓ Imperfect competition and <u>presence of monopoly power in different degrees leading to under-production and higher prices</u> than would exist under conditions of competition. These distort the choices available to consumers and reduce their welfare. ✓ Markets typically fail to provide <u>collective goods</u> which are, by their very nature, consumed in common by all the people.

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- ✓ Externalities which arise when the production and consumption of a good or service affects people and they cannot influence through markets the decision about how much of the good or service should be produced e.g. pollution.
- ✓ Factor immobility which causes unemployment and inefficiency
- ✓ Imperfect information, and
- ✓ Inequalities in the distribution of income and wealth.

Question 10

Explain the instruments available to government under Stabilisation function.

Answer**Expansionary fiscal policy**

- ✓ It is exercised in times of recession.
- ✓ Government increases its expenditure or cuts down taxes or adopts a combination of both so that aggregate demand is boosted up with more money put into the hands of the people.
- ✓ Government follows Deficit Budget to stimulate economic activity.

Contractionary fiscal policy

- ✓ It is exercised in times of inflation.
- ✓ Government cuts its expenditure or increases the taxes or adopts a combination of both so that less money is put into the hands of people.
- ✓ Government follows Surplus Budget to slow down economic activity.

Question 11

How can the externalities affect?

Answer

- ✓ Externalities can be positive or negative.

Negative Externalities

- ✓ Negative externalities occur when the action of one party imposes costs on another party.

Positive Externalities

- ✓ Positive externalities occur when the action of one party confers benefits on another party.

Question 12

Explain the concept of Quasi Public Goods.

Answer**Meaning**

- ✓ These are the goods which possess nearly all of the qualities of the private goods and some of the benefits of public good.
- ✓ These are also called near public goods.

Excludable but desirable

- ✓ It is easy to keep people away from them by charging a price or fee.
- ✓ However, it is undesirable to keep people away from such goods because the

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	society would be better off if more people consume them.
Example	Education Services Health Services
Free Market vs. Government Provision	<ul style="list-style-type: none"> ✓ The combination of virtually infinite benefits and the ability to charge a price results in some quasi-public goods being sold through markets and others being provided by government. As such, people argue that these <u>should not be left to the market alone.</u> ✓ Markets for the quasi public goods are considered to be incomplete markets and their <u>lack of provision by free markets would be considered as inefficiency and market failure.</u>

Question 13

How does the government directly control negative externalities?

Answer

Meaning	<ul style="list-style-type: none"> ✓ These are the controls that <u>openly regulate the actions of those involved in generating negative externalities.</u>
Means of exercising	<ul style="list-style-type: none"> ✓ <u>Production, use and sale</u> of many commodities and services are <u>prohibited</u> in our country. Smoking is completely banned in many public places. ✓ <u>Stringent rules</u> are in place in respect of tobacco advertising, packaging and labeling etc. ✓ Government can frame <u>laws & rules</u> to regulate the actions by producers and consumers. For example, India has enacted the Environment (Protection) Act, 1986. ✓ The government may, through legislation, <u>fix emissions standard</u> which is a legal limit on how much pollutant a firm can emit. The set standard ensures that the firm produces efficiently. If the firm exceeds the limit, it can invite monetary penalties or/and criminal liabilities. The firms have to <u>install pollution-abatement mechanisms</u> to ensure adherence to the emission standards. This means additional expenditure to the firm leading to rise in the firm's average cost. ✓ Another method is to <u>charge an emissions fee</u> which is levied on each unit of a firm's emissions. The firms can minimize costs and enhance their profitability by reducing emissions. ✓ Governments may also <u>form special bodies/ boards</u> to specifically address the problem. For instance, the Ministry of Environment & Forest, the Pollution Control Board of India and the State Pollution Control Boards.

Question 14

What are the problems in administering an efficient pollution tax?

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Answer

- ✓ Pollution taxes are difficult to determine because it is difficult to discover the right level of taxation that would ensure that the private cost plus taxes will exactly equate with the social cost.
- ✓ If the demand for the good is inelastic, the tax may only have an insignificant effect in reducing demand.
- ✓ The method of taxing the polluters involves the use of complex and costly administrative procedures for monitoring the polluters.
- ✓ In case of goods which have inelastic demand, producers will be able to easily shift the tax burden in the form of higher product prices. This will have an inflationary effect and may reduce consumer welfare.
- ✓ It only establishes an incentive system for use of methods which are less polluting.
- ✓ Pollution taxes also have potential negative consequences on employment and investments because high pollution taxes in one country may encourage producers to shift their production facilities to those countries with lower taxes.

Question 15

How does the government intervene in case of demerit goods?

Answer

Complete Ban	✓ Government may enforce <u>complete ban</u> on a demerit good. e.g. Intoxicating drugs. In such cases, the possession, trading or consumption of the good is made illegal.
Persuasion	✓ Government can launch <u>negative advertising campaigns</u> which emphasize the dangers associated with consumption of demerit goods.
Legislations	✓ Government can frame legislations that <u>prohibit the advertising or promotion</u> of demerit goods.
Strict Regulations	✓ Strict regulations may be put in place so as <u>to limit access to the good</u> , especially by vulnerable groups such as children and adolescents.
Regulatory Controls	✓ Government can enforce regulatory controls in the form of <u>spatial restrictions</u> e.g. smoking in public places, sale of tobacco to be away from schools, and time restrictions under which sale at particular times during the day is banned.
High Taxes	✓ Government can impose unusually high taxes on production or purchase of good <u>making them very costly and unaffordable</u> to many, for reducing the consumption of a demerit good.
Minimum Price	✓ The government can fix a minimum price <u>below which the demerit good should not be sold</u> .

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Question 16

Describe the working of Automatic Stabilizers in Recession Phase.

Answer

- ✓ The automatic adjustments work towards stimulating aggregate spending during the recessionary phase.
- ✓ During recession, incomes are reduced. With progressive tax structure, there will be a decline in the proportion of income that is taxed. This would result in lower tax payments as well as some tax refunds.
- ✓ Also, due to increased unemployment, government expenditures increase due to increased transfer payments.
- ✓ Due to above operations, more disposable income is available for consumption with the households.
- ✓ In the absence of such automatic responses, household spending would tend to decrease more sharply and the economy would fall into a deeper recession.

Question 17

What is National Debt and how is it connected to Budget?

Answer

Meaning of National Debt

- ✓ A nation's debt is the difference between its total past deficits and its total past surpluses.
- ✓ If a government has borrowed money over the years to finance its deficits and has not paid it back through accumulated surpluses, then it is said to be in debt.

Impact of Budget

- ✓ A surplus budget reduces national debt, a deficit budget will add to the national debt.

Question 18

Explain essential characteristics of money.

Answer

- ✓ There are some general characteristics that money should possess in order to make it serve its functions as money.
- ✓ Money should be:
 - ❖ generally acceptable
 - ❖ durable or long-lasting
 - ❖ effortlessly recognizable
 - ❖ difficult to counterfeit i.e. not easily reproducible by people
 - ❖ relatively scarce, but has elasticity of supply
 - ❖ portable or easily transported
 - ❖ possessing uniformity; and
 - ❖ divisible into smaller parts in usable quantities or fractions without losing value.

Question 19

Does money offer perfect liquidity?

Answer

- ✓ There are many other assets such as government bonds, deposits and other securities, land, houses etc. which also store value.
- ✓ Despite having the advantages of potential income yield and appreciation in value over time, these other assets are subject to limitations such as storage costs, lack of liquidity and possibility of depreciation in value.
- ✓ Money is the only asset which has perfect liquidity.

Question 20

What are the variables affecting demand for money?

Answer

Income	✓ <u>Higher the income of individuals, higher the expenditure</u> and richer people hold more money to finance their expenditure.
General level of prices	✓ The quantity is directly proportional to the prevailing price level. ✓ <u>Higher the prices, higher should be the holding of money</u> .
Rate of interest	✓ The opportunity cost of holding money is the interest rate a person could earn on other assets. ✓ Therefore, <u>higher the interest rate</u> , higher would be opportunity cost of holding cash and <u>lower the demand for money</u> .
Degree of Financial Innovation	✓ Innovations such as internet banking, application based transfers and automatic teller machines <u>reduce the need for holding liquid money</u> .

Question 21

Explain the precautionary motive of holding the money.

Answer

Meaning	✓ Demand for money arises <u>due to the unforeseen and unpredictable contingencies</u> involving money payments which occur in our day to day life.
Insights	✓ Individuals as well as businesses keep a portion of their income <u>to finance such unanticipated expenditures</u> . ✓ The amount of money demanded under the precautionary motive depends on the size of income, prevailing economic as well as political conditions and personal characteristics of the individual such as optimism/ pessimism, farsightedness etc.
Relationship with Income	✓ Keynes regarded the precautionary balances just as balances under transactions motive as <u>income elastic and by itself not very sensitive to rate of interest</u> .

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Question 22

What are the sources of money supply in the country?

Answer

Decision of
Central
Bank

- ✓ The central banks of all countries are empowered to issue currency and, therefore, the central bank is the primary source of money supply in all countries.
- ✓ The currency issued by the central bank is 'fiat money'.
- ✓ It is backed by supporting reserves and its value is guaranteed by the government. The currency issued by the central bank is, in fact, a liability of the central bank and the government. Therefore, in principle, it must be backed by an equal value of assets mainly consisting of gold and foreign exchange reserves. In practice, however, most countries have adopted a 'minimum reserve system' wherein the central bank is empowered to issue currency to any extent by keeping only a certain minimum reserve of gold and foreign securities.

Supply
responses of
Commercial
Banking
system

- ✓ The total supply of money in the economy is also determined by the extent of credit created by the commercial banks in the country.
- ✓ Banks create money supply in the process of borrowing and lending transactions with the public.
- ✓ Money so created by the commercial banks is called 'credit money'.

Question 23

How is CRR related to money supply?

Answer

How does it
effect?

- ✓ The behaviour of the commercial banks in the economy is reflected in the ratio of their cash reserves to deposits known as the 'reserve ratio'.

Effect of this
ratio

Increase

- ✓ If this ratio increases while all the other variables remain the same, more reserves would be needed.
- ✓ This implies that banks must contract their loans, causing a decline in deposits and hence in the money supply.

Decrease

- ✓ If this ratio falls, there will be greater expansions of deposits because the same level of reserves can now support more deposits and the money supply will increase.

Thus, money multiplier and the money supply are negatively related to the Reserves ratio.

Question 24

Explain TD-DD Ratio and its impact on money multiplier.

Answer**Meaning**

- ✓ It means how much money is kept as time deposits compared to demand deposits.
- ✓ This ratio also has an important implication for the money multiplier.

Effect**Increase**

- ✓ An increase in TD/DD ratio means that greater availability of free reserves and consequent enlargement of volume of multiple deposit expansion and monetary expansion.

Decrease

- ✓ A decrease in TD/DD ratio means that less availability of free reserves and consequent less volume of multiple deposit expansion and monetary expansion.

Thus, money multiplier and the money supply are positively related to the TD-DD ratio.

Question 25

Explain the primary objectives of monetary policy.

Answer**Price stability**

- ✓ Establishment and maintenance of stability in prices has been the most conventional objective which focuses towards controlling inflation.

Economic Stability

- ✓ This objective aims to achieve high level of economy's growth and maintenance of full employment.
- ✓ It was the Great Depression in 1930s and the associated economic crises which resulted in a major shift in the objective of governments' economic policy in favour of Economic Stability from Price Stability.

Question 26

What are the four different mechanisms through which monetary policy influences the price level and the national income?

Answer

- ✓ There are mainly four different mechanisms through which monetary policy influences the price level and the national income. These are:
 - ❖ the interest rate channel,
 - ❖ the exchange rate channel,
 - ❖ the quantum channel (e.g., relating to money supply and credit), and
 - ❖ the asset price channel i.e. via equity and real estate prices.

Question 27

Describe LAF.

Answer

Insights	<ul style="list-style-type: none"> ✓ A central bank is a 'bankers' bank.' ✓ It <u>provides liquidity to banks</u> when the latter face shortage of liquidity.
Meaning	<ul style="list-style-type: none"> ✓ The Liquidity Adjustment Facility (LAF) is a <u>facility extended by the Reserve Bank of India to the scheduled commercial banks</u> (excluding RRBs) and primary dealers <u>to avail of liquidity in case of requirement</u> (or park excess funds with the RBI in case of excess liquidity) <u>on an overnight basis</u> against the collateral of government securities including state government securities.
Objective	<ul style="list-style-type: none"> ✓ Its objective is <u>to assist banks to adjust their day to day mismatches in liquidity.</u>
Operation	<ul style="list-style-type: none"> ✓ The <u>scheduled commercial banks can borrow from the discount window against the collateral of securities</u> like commercial bills, government securities, treasury bills, or other eligible papers.
Role of Repos/ Reverse Repos	<ul style="list-style-type: none"> ✓ Currently, the <u>RBI provides financial accommodation to the commercial banks through repos/ reverse repos</u> under the Liquidity Adjustment Facility (LAF).

Question 28

Which securities are permitted for REPO & Reverse REPO?

Answer

Securities Transacted	<ul style="list-style-type: none"> ✓ The securities transacted can be either <u>government securities or corporate securities</u> or any other securities which the RBI permits for transaction.
Eligible Collaterals	<ul style="list-style-type: none"> ✓ The collaterals used for repo and reverse repo operations consist of primarily <u>Government of India securities</u> i.e. all SLR-eligible transferable Government of India dated securities/ treasury bills.

Question 29

Explain Market Stabilisation Scheme.

Answer

Background	<ul style="list-style-type: none"> ✓ This instrument was <u>introduced in 2004</u> following a MoU between the Reserve Bank of India (RBI) and the Government of India (GOI).
Objective	<ul style="list-style-type: none"> ✓ This instrument has the primary aim of <u>aiding the sterilization operations of the RBI.</u>
Meaning	<ul style="list-style-type: none"> ✓ Sterilization is the process by which the <u>monetary authority sterilizes the effects of significant foreign capital inflows</u> on domestic liquidity by off-loading parts of the stock of government securities held by it.

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Process	<ul style="list-style-type: none"> ✓ Under this scheme, the <u>Government of India borrows from the RBI</u> (such borrowing being additional to its normal borrowing requirements) and <u>issues treasury-bills/ dated securities for absorbing excess liquidity</u> from the market arising from large capital inflows.
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Question 30

What is inflation targeting? Explain in detail.

Answer

Inflation Targeting	<ul style="list-style-type: none"> ✓ <u>Announcement of an official target range for inflation</u> is known as inflation targeting. ✓ The Expert Committee under Urjit Patel to revise the monetary policy framework, in its report in January, 2014 suggested that <u>RBI abandon the 'multiple indicator' approach</u> and make inflation targeting the primary objective of its monetary policy.
Timing of setting target	<ul style="list-style-type: none"> ✓ The inflation target is to be set by the Government of India, in consultation with the Reserve Bank, <u>once in every five years.</u>
Continuous Reporting	<ul style="list-style-type: none"> ✓ The RBI is mandated to publish a Monetary Policy Report <u>every six months</u>, explaining the sources of inflation and the forecasts of inflation for the coming period of six to eighteen months.
Factors constituting failure	<ul style="list-style-type: none"> ✓ The following factors are notified by the central government as constituting a failure to achieve the inflation target : <ul style="list-style-type: none"> ❖ the <u>average inflation is more than the upper tolerance level</u> of the inflation target for any three consecutive quarters; or ❖ the <u>average inflation is less than the lower tolerance level</u> for any three consecutive quarters.
Current Targets	<ul style="list-style-type: none"> ✓ The Central Government has notified 4% Consumer Price Index (CPI) inflation as the target for the period from August 5, 2016 to March 31, 2021 with the <u>upper tolerance limit of 6% and the lower tolerance limit of 2%.</u>

Question 31

Enumerate any 5 advantages of International Trade.

Answer

Increased Efficiency	<ul style="list-style-type: none"> ✓ Competition from foreign goods <u>compels manufacturers, especially in developing countries, to enhance efficiency</u> and profitability by adoption of cost reducing technology and business practices.
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Efficient deployment of productive resources	<ul style="list-style-type: none"> ✓ Efficient deployment of productive resources to their best uses is a direct economic advantage of foreign trade. ✓ Greater efficiency in the use of natural, human, industrial and financial resources <u>ensures productivity gains</u>.
Economies of scale	<ul style="list-style-type: none"> ✓ Huge amount of trade induces the business persons to <u>enlarge their manufacturing capabilities</u> and benefit from economies of large scale production.
Division of labour	<ul style="list-style-type: none"> ✓ The <u>wider market</u> made possible owing to trade induces companies to reap the quantitative and qualitative benefits of extended division of labour.
Enhanced competition	<ul style="list-style-type: none"> ✓ On account of globalization, competition between the domestic industry and rest of the world rises, <u>generating benefits to consumers</u>.

Question 32

How is labour affected negatively due to international trade?

Answer

- ✓ Labour-saving technological change that depress demand for unskilled workers
- ✓ Loss of labourers' bargaining power
- ✓ Downward pressure on wages of semi-skilled and unskilled workers
- ✓ Forced work under unfair circumstances
- ✓ Unhealthy occupational environments

Question 33

What is the concept behind theory of comparative advantage?

Answer

The law of comparative advantage states that even if one nation is less efficient than (has an absolute disadvantage with respect to) the other nation in the production of all commodities, there is still scope for mutually beneficial trade.

Question 34

What is network effect?

Answer

- ✓ Network effects are the way one person's value of a good or service is affected by the value of that good or service to others. The value of the product or service is enhanced as the number of individuals using it increases. This is also referred to as the 'bandwagon effect'.
- ✓ When such an effect is present, value of a good or service is dependent on the number of users using it. Higher the users, higher is the value.
For Example, Mobile App such as Whats App and software like Microsoft Windows.

Question 35

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Discuss Ad-Valorem Tariff.

Answer

Meaning	✓ An ad valorem tariff is levied as a <u>constant percentage of the monetary value of one unit of the imported good.</u>
Example	A 20% ad valorem tariff on any bicycle generates a Rs. 1000 payment on each imported bicycle priced at Rs. 5,000 in the world market; and if the price rises to Rs. 10,000, it generates a payment of Rs. 2,000.
Insights	✓ While ad valorem tariff preserves the protective value of tariff on home producer, it gives <u>incentives to deliberately undervalue the good's price on invoices and bills of lading to reduce the tax burden.</u> Nevertheless, ad valorem tariffs are widely used the world over.

Question 36

What is MFN?

Answer

Meaning	✓ MFN tariffs are what <u>countries promise to impose on imports from other members of the WTO,</u> unless the country is part of a preferential trade agreement (such as a free trade area or customs union).
Nature	✓ MFN rates are the <u>highest (most restrictive) that WTO members charge one another.</u> ✓ Some countries impose higher tariffs on countries that are not part of the WTO.

Question 37

Explain the concept of Escalated Tariff.

Answer

Meaning	✓ It refers to the system wherein the nominal tariff rates on imports of manufactured goods are higher than the nominal tariff rates on intermediate inputs and raw materials, i.e. <u>the tariff on a product increases as that product moves through the value-added chain.</u>
Example	A four percent tariff on iron ore or iron ingots and twelve percent tariff on steel pipes.
Insights	✓ This has special relevance to trade between developed countries and developing countries. ✓ This type of tariff is <u>discriminatory</u> as it protects manufacturing industries in importing countries and dampens the attempts of developing manufacturing industries of exporting countries. <u>Developing countries are thus forced to continue to be suppliers of raw materials without much value addition.</u>

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Question 38

In what condition anti dumping duty is levied?

Answer**Meaning of anti-dumping duty**

- ✓ Anti-dumping duties which are tariffs to offset the effects of dumping which may be initiated as a safeguard instrument by imposition of additional import duties so as to offset the foreign firm's unfair price advantage.

Pre-condition

- ✓ The domestic industry is seriously injured by import competition.
- ✓ Protection is in the national interest.

Example

In January 2017, India imposed antidumping duties on colour-coated or pre-painted flat steel products imported from China and European nations for a period not exceeding six months and for jute and jute products from Bangladesh and Nepal.

Question 39

Are NTMs same as NTBs?

Answer**Meaning of NTMs**

- ✓ Non-tariff measures (NTMs) are policy measures, other than ordinary customs tariffs, that can potentially have an economic effect on international trade in goods, changing quantities traded, or prices or both.

Comparison with Non-Tariff Barriers

- ✓ Compared to non-tariff barriers which are simply discriminatory non-tariff measures imposed by governments can be on positive as well as negative side.
- ✓ NTMs have a wider scope whereas NTBs gave a narrow scope.

Question 40

Explain Trade Related Investment Measures.

Answer**Meaning**

- ✓ These measures include rules on local content requirements that mandate a specified fraction of a final good should be produced domestically.

Various Means

- ✓ Such conditions may be in following forms :
 - ❖ requirement to use certain minimum levels of locally made components, (25 percent of components of automobiles to be sourced domestically)
 - ❖ restricting the level of imported components, and
 - ❖ limiting the purchase or use of imported products to an amount related to the quantity or value of local products that it exports. (A firm may import

only up to 75 % of its export earnings of the previous year)

Question 41

What are the types of agreements under Trade Negotiations?

Answer

Unilateral trade agreements

- ✓ The importing country offers trade incentives in order to encourage the exporting country to engage in international economic activities that will improve the exporting country's economy.
E.g. Generalized System of Preferences.

Bilateral Agreements

- ✓ Bilateral Agreements are agreements which set rules of trade between two countries, two blocs or a bloc and a country.
- ✓ These may be limited to certain goods and services or certain types of market entry barriers.
E.g. EU-South Africa Free Trade Agreement; ASEAN-India Free Trade Area.

Question 42

Describe Trading Bloc.

Answer

Meaning

- ✓ It is a group of countries that have a free trade agreement between themselves and may apply a common external tariff to other countries.

Example

Arab League (AL), European Free Trade Association (EFTA).

Question 43

Why did GATT lose its relevance?

Answer

- ✓ The GATT lost its relevance by 1980s because
 - ❖ it was obsolete to the fast evolving contemporary complex world trade scenario characterized by emerging globalisation
 - ❖ international investments had expanded substantially
 - ❖ intellectual property rights and trade in services were not covered by GATT
 - ❖ world merchandise trade increased by leaps and bounds and was beyond its scope
 - ❖ the ambiguities in the multilateral system could be heavily exploited
 - ❖ efforts at liberalizing agricultural trade were not successful
 - ❖ there were inadequacies in institutional structure and dispute settlement system
 - ❖ it was not a treaty and therefore terms of GATT were binding only insofar as they are not incoherent with a nation's domestic rules.

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Question 44

Explain National Treatment Principle of WTO.

Answer**Meaning**

- ✓ The National Treatment Principle is complementary to the MFN principle.
- ✓ GATT Article III requires that with respect to internal taxes, internal laws, etc. applied to imports, treatment not less favourable than that which is accorded to like domestic products must be accorded to all other members.
- ✓ In other words, a country should not discriminate between its own and foreign products, services or nationals.

Example

Once imported apples reach Indian market, they cannot be discriminated against and should be treated at par in respect of marketing opportunities, product visibility or any other aspect with locally produced apples.

Question 45

What are the major concerns of Developing Countries w.r.t. WTO?

Answer**Primary area neglected**

- ✓ The developing countries contend that the real expansion of trade in the three key areas of agriculture, textiles and services has been dismal.

No market access

- ✓ Protectionism and lack of willingness among developed countries to provide market access on a multilateral basis has driven many developing countries to seek regional alternatives.

Problem in implementation

- ✓ The developing countries have raised a number of issues in the Doha Agenda in respect of the difficulties that they face in implementing the present agreements.

High tariffs on main products

- ✓ Developing countries complain that they face exceptionally high tariffs on selected products in many markets and this obstructs their vital exports. Examples are tariff peaks on textiles, clothing, and fish and fish products.

Tariff escalation

- ✓ The importing country protects its processing or manufacturing industry by setting lower duties on imports of raw materials and components, and higher duties on finished products.

✓

Difficult adjustment

- ✓ The least-developed countries find themselves disproportionately disadvantaged and vulnerable with regard to adjustments due to lack of human as well as physical capital, poor infrastructure, inadequate institutions, political instabilities etc.

Question 46

Explain Direct & Indirect Quote.

Answer

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Direct quote	<ul style="list-style-type: none"> ✓ A direct quote is the number of <u>units of a local currency exchangeable for one unit of a foreign currency</u>. For example, Rs. 66/US\$ means that an amount of Rs. 66 is needed to buy one US dollar or Rs. 66 will be received while selling one US dollar. ✓ It is also called <u>European Currency Quotation</u>. ✓ In a direct quotation, the foreign currency is the base currency and the domestic currency is the counter currency.
Indirect quote	<ul style="list-style-type: none"> ✓ An indirect quote is the number of <u>units of a foreign currency exchangeable for one unit of local currency</u>. For example: \$ 0.0151 per rupee. ✓ It is also called <u>American Currency Quotation</u>. ✓ In an indirect quotation, the domestic currency is the base currency and the foreign currency is the counter currency.

Question 47

What are the advantages and disadvantages of Flexible Rate Regime?

Answer

Advantages of a flexible rate regime	<ul style="list-style-type: none"> ✓ It is <u>efficient and highly transparent</u> as the exchange rate is free to fluctuate in response to the supply of and demand for foreign exchange in the market. ✓ Central bank and /or government are <u>free to pursue its own independent monetary policy</u>. ✓ As there is no obligation or necessity to intervene in the currency markets, the central bank is <u>not required to maintain a huge foreign exchange reserves</u>.
Dis-advantages of a flexible rate regime	<ul style="list-style-type: none"> ✓ Volatile exchange rates generate a <u>lot of uncertainties</u> in relation to international transactions. ✓ This exchange rate <u>adds a risk premium</u> to the costs of goods and assets traded across borders.

Question 48

Describe Currency Appreciation & Currency Depreciation.

Answer

Currency Appreciation	<ul style="list-style-type: none"> ✓ Currency appreciates when its <u>value increases with respect to the value of another currency</u> or a basket of other currencies.
Currency Depreciation	<ul style="list-style-type: none"> ✓ Currency depreciates when its <u>value falls with respect to the value of another currency</u> or a basket of other currencies.

Question 49

What are the main forms of FDI?

Answer

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- ✓ Opening of a subsidiary or associate company in a foreign country.
- ✓ Equity injection into an overseas company.
- ✓ Acquiring a controlling interest in an existing foreign company.
- ✓ Mergers and acquisitions(M&A).
- ✓ Joint venture with a foreign company.
- ✓ Green field investment (establishment of a new overseas affiliate for freshly starting production by a parent company).
- ✓ Joint development of natural resources.
- ✓ Purchase of companies in the country receiving foreign capital.

Question 50

List few problems associated with FDI.

Answer

Capital Intensive Techniques	<ul style="list-style-type: none"> ✓ FDI's are likely to concentrate on capital-intensive methods of production and service so that they need to <u>hire only relatively few workers</u>. ✓ Such technology is inappropriate for a labour-abundant country as it <u>does not support generation of jobs</u>.
Regional Disparity	<ul style="list-style-type: none"> ✓ FDI <u>flows towards those regions</u> or states which are well endowed in terms of <u>natural resources and availability of infrastructure</u>. It may lead to regional disparity.
Loss of Tax Revenue	<ul style="list-style-type: none"> ✓ If the <u>foreign corporations are able to secure incentives</u> in the form of tax holidays or similar provisions, the host country loses tax revenues.
Crowding out effect	<ul style="list-style-type: none"> ✓ The foreign firms may partly finance their domestic investments by borrowing funds in the host country's capital market. ✓ This action can <u>raise interest rates in the host country</u> and lead to a decline in domestic investments through 'crowding-out' effect.
Less investment for development needs	<ul style="list-style-type: none"> ✓ <u>Suppliers of funds in developing economies would prefer foreign firms due to perceived lower risks</u> and such shifts of funds may divert capital away from investments which are crucial for the development needs of the country.
Stress on Balance of Payments	<ul style="list-style-type: none"> ✓ Foreign corporations also have a tendency to use their usual input suppliers which can lead to increased imports. ✓ Also, <u>large scale repatriation of profits</u> can be stressful on the balance of payments.
No development of human resource	<ul style="list-style-type: none"> ✓ <u>Jobs that require expertise and entrepreneurial skills</u> for creative decision making may generally be <u>retained in the home country</u> and therefore the host country is left with routine management jobs that demand only lower levels of skills and ability.

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<p>Focus on elite goods/ services</p>	<p>✓ High profit orientation of foreign direct investors tends to promote production of <u>items of elite and popular consumption instead of essential ones.</u></p>
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