# CHAPTER 1 - DETERMINATION OF NATIONAL INCOME

| 1. | Q.1a | MTP Mar 23 |
|---|---|---|
| | **Why Keynesian Equilibrium does not occur at Full Employment level?** | |
| Ans. | Keynesian equilibrium with equality of planned aggregate expenditures and output need not take place at full employment. If the aggregate expenditure line intersects the 45-degree line at the level of potential GDP, then there is full employment equilibrium. There is no recession, and unemployment is at the natural rate. But there is no guarantee that the equilibrium will occur at the potential GDP level of output. The economy can settle at any equilibrium which might be higher or lower than the full employment equilibrium. | |

| 2. | Q.1b | MTP Mar 23 |
|---|---|---|
| | **Outline the difficulties in measurement of national income in India?** | |
| Ans. | There are many conceptual difficulties related to measurement which are difficult to resolve, such as:<br>(a) lack of an agreed definition of national income,<br>(b) accurate distinction between final goods and intermediate goods,<br>(c) issue of transfer payments,<br>(d) services of durable goods,<br>(e) difficulty of incorporating distribution of income,<br>(f) valuation of a new good at constant prices, and valuation of government services | |

| 3. | Q.1c | MTP Mar 23 |
|---|---|---|
| | **Calculate value of output from the following data:** | |

| Sr No. | Particulars | In lakhs |
|---|---|---|
| 1. | Net value added at factor cost | 800 |
| 2. | Intermediate consumption | 500 |
| 3. | Excise duty | 400 |
| 4. | Subsidy | 60 |
| 5. | Depreciation | 80 |

Ans.

NVA at FC = Value of Output – Intermediate Consumption – Depreciation – (Excise Duty – Subsidy)

Thus, Value of output = Net value added at factor cost + Intermediate consumption + Depreciation + (Excise duty-Subsidy)

= 800 + 500 + 80 + (400-60)

= ₹ 1720 lakhs

| 4. | Q.2a | MTP Mar 23 |
|---|---|---|
| | **The nominal and real GDP respectively of a country in a particular year are Rs 5000 Crores and Rs 6000 Crores respectively. Calculate GDP deflator and analyze the on the level of prices of the year in comparison with the base year.** | |
| Ans. | Nominal GDP = 5000 Crores     Real GDP = 6 000 Crores | |

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| | DP Deflator = $\frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$<br>= 5000÷6000 × 100<br>= 83.33<br>The price level has fallen since GDP deflator is less than 100 at 83.33 |

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| **5.** | **Q.2b** | **MTP Mar 23** |
| | **Calculate Gross value at factor cost** | |

| Sr No. | Particulars | |
|---|---|---|
| 1. | Units of output sold (Unit) | 1000 |
| 2. | Price per unit of output (₹) | 30 |
| 3. | Depreciation (₹) | 1000 |
| 4. | Intermediate cost (₹) | 12000 |
| 5. | Closing Stock (₹) | 3000 |
| 6. | Opening Stock (₹) | 2000 |
| 7. | Excise (₹) | 2500 |
| 8. | Sales Tax (₹) | 3500 |

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|---|---|
| **Ans.** | Gross value at factor cost = Total Sales + Change in Stock - Intermediate Consumption – Net Indirect Tax<br>= (1000 x 30) + (3000 - 2000) – 12000 - (2500 + 3500)<br>= ₹ 13000 |

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| **6.** | **Q.2c** | **MTP Mar 23** |
| | **What are the factors that causes leakages in the multiplier?** | |
| **Ans.** | The leakages are caused due to:<br>• progressive rates of taxation which result in no appreciable increase in consumption despite increase in income.<br>• high liquidity preference and idle saving or holding of cash balances and an equivalent fall in marginal propensity to consume.<br>• increased demand for consumer goods being met out of the existing stocks or through imports.<br>• additional income spent on purchasing existing wealth or purchase of government securities and shares from shareholders or bond holders.<br>• undistributed profits of corporations<br>• part of increment in income used for payment of debts.<br>• case of full employment additional investment will only lead to inflation, and<br>• scarcity of goods and services despite having high MPC | |

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| **7.** | **Q.5d** | **MTP Mar 23** |
| | **Suppose C= 80 + 0.40 (Y- T + TR); I = 400; T= 20+0.5Y; TR= 50; G =200 Find out equilibrium level of Income?** | |
| **Ans.** | Y = C + I + G<br>Y= 80 + 0.40 (Y- T + TR) + I+ G<br>Y = 100 +0.40(Y – 20 - 0.5Y + 50) + 400 + 200<br>Y = 100 + 0.40Y – 8- 0.2Y + 20 + 600 | |

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| | Y = 712 + 0.2Y<br>Y-0.2Y = 712<br>0.8 Y = 712<br>Y = 712 ÷ 0.8<br>= 890 |

| 8. | Q.1a | MTP April 23 |
|---|---|---|
| | **What is the distinction between the Personal Income and Disposal Personal Income?** | |
| **Ans.** | While national income is income earned by factors of production, Personal Income is the income received by the household sector including Non-Profit Institutions Serving Households. Thus, national income is a measure of income earned and personal income is a measure of actual current income receipts of persons from all sources which may or may not be earned from productive activities during a given period.<br>Disposable personal income is a measure of amount of the money in the hands of the individuals that is available for their consumption or savings. Disposable personal income is derived from personal income by subtracting the direct taxes paid by individuals and other compulsory payments made to the government. | |

| 9. | Q.1b | MTP April 23 , Sept 22 |
|---|---|---|
| | **What are the significance of Gross Investment?** | |
| **Ans.** | Gross Investment is that part of country's total expenditure which is not consumed but added to the nation's fixed tangible assets and stocks. It consists of the acquisition of fixed assets and the accumulation of stocks. The stock accumulation is in the form of changes in stock of raw materials, fuels, finished goods and semi-finished goods awaiting completion. Thus, gross investment includes final expenditure on machinery and equipment and own account production of machinery and equipment, expenditure on construction, expenditure on changes in inventories, and expenditure on the acquisition of valuables such as, jewellery and works of art. | |

| 10. | Q.1c | MTP April 23 |
|---|---|---|
| | **From the following data, calculate National income by Income and Expenditure Method:** | |

| Sr No. | Particulars | ₹ in crores |
|---|---|---|
| 1. | Government final consumption expenditure | 165 |
| 2. | Compensation of Employees | 200 |
| 3. | Rent | 300 |
| 4. | Private final consumption expenditure | 600 |
| 5. | Gross domestic capital formation | 80 |
| 6. | Mixed Income of self employed | 75 |
| 7. | Net factor income paid from abroad | 60 |
| 8. | Interest | 40 |
| 9. | Profit | 230 |
| 10. | Net exports | 60 |

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| **Ans.** | National Income (NNPFC) by Income Method = Compensation of Employees + Rent+ Interest + Profit + Mixed Income of Self Employed + Net Factor Income from abroad = 200+300+40+230+75+60<br>= ₹905 Crore<br>National Income (NNPFC) by Expenditure Method = Private final consumption expenditure + Government final consumption expenditure + Gross domestic capital formation+ Net Exports = 600 + 165 + 80 + 60<br>= ₹ 905 crore |

| **11.** | **Q.2a** | **MTP April 23** |
|---|---|---|
| | **What is the classical theory of determination of National Income?** | |
| **Ans.** | The classical economists maintained that the economy is self-regulating and is always capable of automatically achieving equilibrium at the 'natural level' of real GDP or output, which is the level of real GDP that is obtained when the economy's resources are fully employed. While circumstances arise from time to time that cause the economy to fall below or to exceed the natural level of real GDP, wage and price flexibility will bring the economy back to the natural level of real GDP. If an excess in the labour force (unemployment) or products exist, the wage or price of these will adjust to absorb the excess. According to them, there will be no involuntary unemployment. | |

| **12.** | **Q.2b** | **MTP April 23** |
|---|---|---|
| | **What is the relationship between marginal propensity to Consume (MPC) and Multiplier?** | |
| **Ans.** | Multiplier refers to the phenomenon whereby a change in an injection of expenditure will lead to a proportionately larger change (or multiple changes) in the equilibrium level of national income. The MPC, on which the multiplier effect of increase in income depends, is high in underdeveloped countries; but ironically the value of multiplier is low. Due to structural inadequacies, increase in consumption expenditure is not generally accompanied by increase in production. E.g., increased demand for industrial goods consequent on increased income does not lead to increase in their real output; rather prices tend to rise | |

| **13.** | **Q.2c** | **MTP April 23** |
|---|---|---|
| | **In a three-sector economy what role does the Government Play?** | |
| **Ans.** | The government sector adds the following key flows to the model:<br>(i) Taxes on households and business sector to fund government purchases.<br>(ii) Transfer payments to household sector and subsidy payments to the business sector.<br>(iii) Government purchases goods and services from business sector and factors of production from household sector, and<br>(iv) Government borrowing in financial markets to finance the deficits occurring when taxes fall short of government purchases | |

| 14. | Q.1a | MTP Sept 22 |
|---|---|---|
| | **How the measurement of national Income in India is done?** | |
| **Ans.** | National Accounts Statistics (NAS) in India are compiled by National Accounts Division in the Central Statistics Office, Ministry of Statistics and Programme Implementation (MOSPI). Annual as well as quarterly estimates are published. This publication is the key source-material for all macroeconomic data of the country. As per the mandate of the Fiscal Responsibility and Budget Management Act 2003, the Ministry of Finance uses the GDP numbers (at current prices) to determine the fiscal targets. | |

| 15. | Q.1b | MTP Sept 22, RTP May 23 |
|---|---|---|
| | **What is the distinction between classical and Keynesian theory in the determination of national income?** | |
| **Ans.** | The classical economists maintained that the economy is self-regulating and is always capable of automatically achieving equilibrium at the 'natural level' of real GDP or output, which is the level of real GDP that is obtained when the economy's resources are fully employed. While circumstances arise from time to time that cause the economy to fall below or to exceed the natural level of real GDP, wage and price flexibility will bring the economy back to the natural level of real GDP. If an excess in the labour force (unemployment) or products exist, the wage or price of these will adjust to absorb the excess. According to them, there will be no involuntary unemployment.<br><br>Keynes argued that markets would not automatically lead to full-employment equilibrium and the resulting natural level of real GDP. The economy could settle in equilibrium at any level of unemployment. Keynesians believe that prices and wages are not so flexible; they are sticky, especially downward. The stickiness of prices and wages in the downward direction prevents the economy's resources from being fully employed and thereby prevents the economy from returning to the natural level of real GDP. | |

| 16. | Q.5c | MTP Sept 22 |
|---|---|---|
| | **What is the distinction between Nominal GDP and Real GDP?** | |
| **Ans.** | When GDP is estimated on the basis of current year's market prices, it is called 'nominal GDP' or 'GDP at current prices. For example, GDP of year 2020-21 may be measured using prices of 2020-21. Nominal GDP changes from year to year for two reasons. First, the amount of goods and services produced changes, and second, market prices change. Changes in GDP due to changes in prices fail to correctly explain the performance of the economy in producing goods and services.<br><br>Real GDP is calculated in such a way that the goods and services produced in a particular year are evaluated at some constant set of prices or constant prices. In other words, it is calculated using the prices of a selected 'base year'. For example, if 2011-12 is selected as the base year, then real GDP for 2020-21 will be calculated by taking the quantities of all goods and services produced in 2020-21 and multiplying them by their 2011-12 prices. | |

| 17. | Q.1c | MTP Sept 22 |
|---|---|---|

Calculate the National Income with the help of Income Method and Expenditure Method?

| Item | In Crore |
|---|---|
| Net-factor income from abroad | 50 |
| Compensation of employees | 1000 |
| Net Indirect taxes | 150 |
| Rent | 500 |
| Profit | 700 |
| Private final consumption expenditure | 1500 |
| Net domestic capital formation | 600 |
| Depreciation | 200 |
| Interest | 500 |
| Mixed Income of self employed | 900 |
| Export | 90 |
| Import | 60 |
| Government final Consumption expenditure | 1200 |
| Operating surplus | 1700 |
| Employer's Contribution to social security Scheme | 250 |

**Ans.** By Income Method

NNPFC or National Income = Compensation of employees + Operating surplus + Mixed Income of self-employed + NFIA

= 1000+ 1700 + 900 + 50

= 3650 Cr

By Expenditure Method

GDPMP = Private Final Consumption Expenditure + Government Final consumption expenditure + Gross domestic Capital formation (Net domestic capital formation + depreciation) + Net Export

= 1500 + 1200 + (600+200) +30

= 3530 Cr

| 18. | Q.5d | MTP Sept 22 |
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For an Economy $C = 40 + 0.75Yd$,

$I = 60$

$G = 75$

| | |
|---|---|
| | Transfer Payment = 100<br>Income Tax = 0.2 y<br>Calculate the equilibrium of Income |
| **Ans.** | Y = Y – Tax + Transfer Payments<br>= Y-0.2y + 100<br>= 0.8Y+100<br>C = 40 + 0.75Yd<br>= 40 + 0.75(0.8Y +100)<br>= 40 + 0.6Y + 75<br>= 115 +0.6Y<br>Now<br>Y = C + I +G<br>Y = 115 +0.6Y + 60 +75<br>Y-0.6Y = 250<br>0.4Y = 250<br>Y = 250/0.4 = 625 cr |

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| **19.** | **Q.1a** | **MTP Oct 22** |
| | **What is the distinction between Production Taxes and Product Taxes?** | |
| **Ans.** | Production taxes or subsidies that are paid or received in relation to production and are independent of the volume of actual production. Examples of production taxes are land revenues, stamps and registration fees and tax on profession, factory license fee, taxes to be paid to the local authorities, pollution tax etc. Examples of production subsidies are subsidies to railways, subsidies to village and small industries. Product taxes or subsidies that are paid or received on per unit of product. Examples of product taxes are excise duties, sales tax, service tax and import-export duties. Examples of product subsidies are food, petroleum, and fertilizer subsidies | |

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| **20.** | **Q. 1b** | **MTP Oct 22** |
| | **What is the System of National Accounts (SNA)?** | |
| **Ans.** | SNA, developed by United Nations, provides a comprehensive conceptual and accounting framework for compiling and reporting macroeconomic statistics for analyzing and evaluating the performance of an economy | |

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|---|---|---|
| **21.** | **Q.1c** | **MTP Oct 22** |
| | **Calculate the Operating Surplus with the help of the following data -** | |

| Particulars | ₹ In Crores |
|---|---:|
| Sales | 3000 |
| Compensation of employees | 700 |
| Intermediate consumption | 500 |
| Rent | 300 |
| Interest | 200 |
| Net indirect tax | 800 |
| Consumption of Fixed Capital | 100 |

| | Mixed Income of Self Employed | 200 |
|---|---|---|
| **Ans.** | $GVA_{MP}$ = Gross Value $Output_{MP}$ – Intermediate consumption<br>= (Sales + change in stock) – Intermediate consumption<br>= 3000-500 = 2500<br>$GDP_{MP}$ = $GVA_{MP}$ = 2500 Crores<br><br>$NDP_{MP}$ = $GDP_{MP}$ – consumption of fixed capital<br>= 2500 – 100 = 2400 Crores<br><br>$NDP_{FC}$ = $NDP_{MP}$ – NIT<br>= 2400 – 800 = 1600 Crores<br><br>$NDP_{FC}$ = Compensation of employees + Operating surplus + Mixed income of Self Employed<br>1600 = 700+ 200 + Operating Surplus<br>Operating Surplus = 700Cr | |

| 22. | Q.2a | MTP Oct 22 |
|---|---|---|
| | **Calculate Marginal Propensity to Save (MPS) and Marginal Propensity to Consume (MPC) from the following data:** | |

| Income (₹) ( Y ) | Consumption (₹) ( C ) |
|---|---|
| 6000 | 5000 |
| 10000 | 7000 |

**Ans.**

MPC = $\Delta C/\Delta Y$ =7000-5000 ÷10000-6000 =2000/4000

MPC =0.50

As we know, MPC + MPS = 1

Thus MPS = 1-MPC

MPS = 1- 0.50

MPS = 0.50

| 23. | Q.2b | MTP Oct 22, PYQ May 22, RTP May 23 |
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**What is Circular flow of Income?**

**or**

**Describe the relevance of Circular Flow of Income in the Measurement of National Income.**

**Ans.**

Circular flow of income refers to the continuous interlinked phases in circulation of production, income generation and expenditure involving different sectors of the economy.

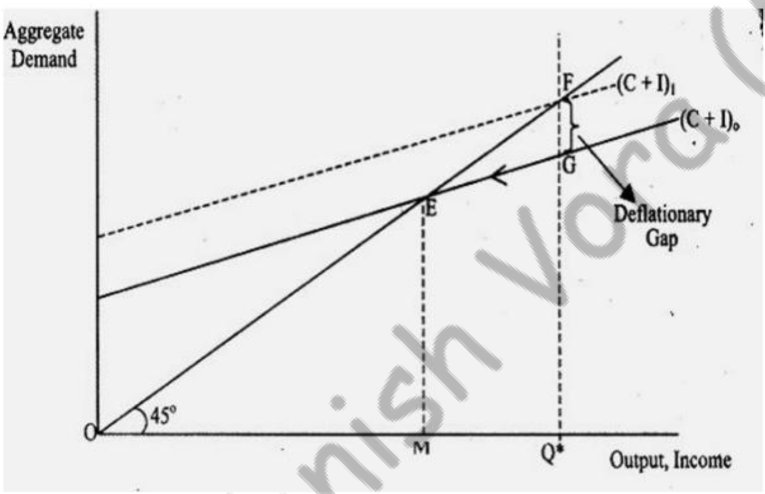
(i) In the production phase, firms produce goods and services with the help of factor services.

(ii) In the income or distribution phase, the flow of factor incomes in the form of rent, wages, interest and profits from firms to the households occurs

(iii) In the expenditure or disposition phase, the income received by different factors of production is spent on consumption goods and services and investment goods. This expenditure leads to further production of goods and services and sustains the circular flow.

| 24. | Q.2c | MTP Oct 22 |
|---|---|---|
| | What do you understand by Inflationary gap? | |
| Ans. | If the aggregate demand is for an amount of output greater than the full employment level of output, then we say there is excess demand. Excess demand gives rise to an 'inflationary gap' | |

| 25. | Q.8b(ii) | PYQ Nov 22 |
|---|---|---|
| | Explain briefly the Deflationary Gap. | |
| Ans. | Deflationary Gap: If the aggregate demand is for an amount of output less than the full employment level of output, then we say there is deficient demand. Deficient demand gives rise to a 'deflationary gap'.<br>A deflationary gap is thus a measure of the extent of deficiency of aggregate demand, and it causes the economy's income, output, and employment to decline, thus pushing the economy to under- employment equilibrium. The macro- equilibrium occurs at a level of GDP less than potential GDP; thus, there is cyclical unemployment i.e. rate of unemployment is higher than the natural rate. | |




Deficient Demand: Deflationary Gap

| 26. | Q.1a | RTP May 23 |
|---|---|---|
| | What is the significance of Intermediate Good? | |
| Ans. | Intermediate goods refer to those goods which are used either for resale or for further production in the same year. They do not end up in final consumption and are not capital goods either. The intermediate goods or services may be either transformed or used up by the production process. They have derived demand. Intermediate goods are used up in the same year; if they remain for more than one year, then they are treated as final goods. Intermediate consumption consists of the value of the goods and services consumed as inputs by a process of production, excluding fixed assets whose consumption is recorded as consumption of fixed capital. Intermediate goods used to produce other goods rather than being sold to final purchasers are not counted as it would involve double counting. | |

| 27. | Q.1c | RTP May 23 |
|---|---|---|
| | Calculate the Depreciation from the following data? | |

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|---|---|---|
| | | ₹ in Cr. |
| | GDP at Market Price (GDPMP) | 850000 |
| | Net Factor Income from abroad | -250 |
| | Aggregate amount of Indirect taxes | 560 |
| | Subsidies | 50 |
| | National Income (NNPFC) | 750000 |
| Ans. | $GDP_{MP} = NNP_{FC}$ - NFIA + NIT +Depreciation<br>850000 = 750000- (-250) + (560-50) + Depreciation<br>850000 = 750000 + 250 + 510 + Depreciation<br>850000 = 750760 + Depreciation<br>Depreciation = 850000 – 750760<br>= ₹ 99240 cr | |

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| 28. | Q.2c | RTP May 23 |

Calculate National Income by Expenditure Method and Income Method with the help of following data:

| Items | ₹ In Crores |
|---|---|
| Compensation of employees | 1000 |
| Net factor income from Abroad | 10 |
| Net indirect taxes | 150 |
| Profit | 900 |
| Private final consumption expenditure | 4,000 |
| Net domestic capital formation | 550 |
| Consumption of fixed capital | 120 |
| Rent | 600 |
| Interest | 720 |
| Mixed income of self-employed | 800 |
| Net export | 40 |
| Govt. final consumption expenditure | 1000 |
| Operating surplus | 160 |
| Employer's contribution to social security scheme | 400 |

**Ans.**

**By Expenditure method**

$GDP_{MP}$ = Private final consumption expenditure + Government final consumption expenditure + Gross domestic capital formation (Net domestic capital formation+ depreciation) + Net export
= 4000 + 1000 + (550 + 120) + 40 = 5710 cr

$NNP_{FC}$ or NI = $GDP_{MP}$- depreciation + NFIA – NIT
= 5710 – 120 + 10 – 150 = 5450 cr

**By Income method**

$NNP_{FC}$ or NI = Compensation of employees + Operating Surplus + Mixed income of self-employed + NFIA
= 1000 + 160 + 800 + 10 = 1970 cr

| 29. | Q.4b | RTP May 23 |
|---|---|---|
| | **Explain the difference between the Classical and Keynesian theory of International Trade?** | |
| **Ans.** | The classical economists maintained that the economy is self-regulating and is always capable of automatically achieving equilibrium at the 'natural level' of real GDP or output, which is the level of real GDP that is obtained when the economy's resources are fully employed. While circumstances arise from time to time that cause the economy to fall below or to exceed the natural level of real GDP, wage and price flexibility will bring the economy back to the natural level of real GDP. If an excess in the labour force (unemployment) or products exist, the wage or price of these will adjust to absorb the excess. According to them, there will be no involuntary unemployment.<br><br>Keynes argued that markets would not automatically lead to full-employment equilibrium and the resulting natural level of real GDP. The economy could settle in equilibrium at any level of unemployment. Keynesians believe that prices and wages are not so flexible; they are sticky, especially downward. The stickiness of prices and wages in the downward direction prevents the economy's resources from being fully employed and thereby prevents the economy from returning to the natural level of real GDP. Therefore, output will remain at less than the full employment level as long as there is insufficient spending in the economy. This was precisely what was happening during the great depression. | |

| 30. | Q.1a | RTP Nov 22 |
|---|---|---|
| | **What is the Value-added Method in the National Income Accounting?** | |
| **Ans.** | The value-added method measures the contribution of each producing enterprise in the domestic territory of the country in an accounting year and entails consolidation of production of each industry less intermediate purchases from all other industries. This method of measurement shows the unduplicated contribution by each industry to the total output. The values of the following items are also included:<br>(i) Own account production of fixed assets by government, enterprises, and households.<br>(ii) Imputed value of production of goods for self- consumption, and<br>(iii) Imputed rent of owner-occupied houses.<br>(iv) Change in stock (inventory) | |

| 31. | Q.1b | RTP Nov 22 |
|---|---|---|
| | **In a three-sector model what role does the government play?** | |
| **Ans.** | The three-sector Keynesian model is commonly constructed assuming that government purchases are autonomous. The equilibrium national income is determined at a point where both aggregate demand and aggregate supply are equal,<br>that is,<br>$AD = Y = AS$<br>$C + I + G = Y = C + S + T$<br>The autonomous expenditure components namely, investment and government spending do not directly depend on income and are exogenous variables determined by factors outside the model. | |

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| | The government influences the level of income through taxes, transfer payments, government purchases and government borrowing. |

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| **32.** | **Q.1c** | **RTP Nov 22** |

**Calculate Net National Product at Market Price**

| Items | ₹ in Thousand Cr. |
|---|---|
| Compensation in employees | 800 |
| Profit | 300 |
| Rent | 200 |
| Mixed income of self employed | 600 |
| Net Factor income from abroad | 25 |
| Interest | 60 |
| Import | 40 |
| Export | 15 |
| Consumption of fixed Capital | 30 |
| Net Indirect taxes | 20 |
| Net current transfer to abroad | 10 |

**Ans.** $NDP_{FC}$ = Compensation of employees + Mixed Income of self employed + Rent + Interest + Profit
= 800+600+200+60+300
= ₹ 19,600 Cr.

National Income ($NNP_{FC}$) = $NDP_{FC}$ + NFIA (Factor Income from abroad – factor income to abroad)
= 1960 ( -25-10)
= ₹ 1915 Cr.

$NNP_{MP}$ = $NNP_{FC}$ + Net Indirect taxes
$NNP_{MP}$ = 1915 + 20
= ₹ 1935 Cr.

| | | |
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| **33.** | **Q.2a** | **RTP Nov 22** |

**What are the Challenges in compilation in National Income Accounting?**

**Ans.** The Challenges in compiling in National Income Accounting is as under:
(a) production for self-consumption,
(b) absence of recording of incomes due to illiteracy and ignorance,
(c) lack of proper occupational classification, and
(d) accurate estimation of consumption of fixed capital
(e) Inadequacy of data and lack of reliability of available data,
(f) presence of non-monetized sector

| | | |
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| **34.** | **Q.2c(ii)** | **RTP Nov 22** |

**What will be the value of average propensity to save when**
**(i) C = 500 at Y = 2000**

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|---|---|
| | (ii) S = 650 at Y 1500 |
| **Ans.** | (i) APS = S/Y, S = Y-C = 2000-500 = 1500,<br>Therefore, APS = S/Y = 1500/2000 = 0.75<br><br>(ii) When S = 650 and Y = 1500, APS = S/Y = 650/1500 = 0.433 |

| 35. | Q.3b | RTP Nov 22 |
|---|---|---|
| | **What are the factors that causes leakages in the multiplier?** | |
| **Ans.** | Multiplier refers to the phenomenon whereby a change in an injection of expenditure will lead to a proportionately larger change (or multiple changes) in the equilibrium level of national income. The investment multiplier explains how many times the equilibrium aggregate income increases as a result of an increase in autonomous investment.<br><br>• progressive rates of taxation which result in no appreciable increase in consumption despite increase in income<br>• high liquidity preference and idle saving or holding of cash balances and an equivalent fall in marginal propensity to consume<br>• increased demand for consumer goods being met out of the existing stocks or through imports<br>• additional income spent on purchasing existing wealth or purchase of government securities and shares from shareholders or bond holders<br>• undistributed profits of corporations<br>• part of increment in income used for payment of debts<br>• case of full employment additional investment will only lead to inflation,<br>• scarcity of goods and services despite having high MPC | |

| 36. | Q.7a | PYQ May 22 |
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**Following information, relating to a particular financial year, are given as under:**

| | ₹in Crores |
|---|---|
| Sales | 3,500 |
| Intermediate consumption | 400 |
| Closing Stock | 300 |
| Opening Stock | 200 |
| Net indirect tax | 600 |
| Mixed income | 200 |
| Consumption of fixed capital | 400 |
| Compensation of employees | 400 |

**Compute:**

(i) GVAMP

(ii) NDPMP

(iii) Operating Surplus

**Ans.** (i) GVAMP = Sales + Change in stock – Intermediate Consumption

| | |
|---|---|
| | = 3,500 + (300 – 200) – 400 = **₹ 3,200 Crores**<br><br>(ii) **NDP$_{MP}$** = GDP$_{MP}$ – Consumption of Fixed capital<br>= 3,200 – 400 [here GDP$_{MP}$ = GVA$_{MP}$]<br>= **₹ 2,800 Crores**<br><br>(iii) NDP$_{FC}$ = NDP$_{MP}$ – Net Indirect Taxes<br>= 2800 – 600 = ₹ 2,200 Crores<br>NDP$_{FC}$ = Compensation of employees + Operating surplus + Mixed Income<br>2,200 = 400 + Operating Surplus + 200<br>**Operating Surplus** = 2,200 – 600 = **₹ 1600 Crores** |

| 37. | Q.9a(ii) | PYQ May 22 |
|---|---|---|
| | **What is aggregate Demand Function?** | |
| **Ans.** | Aggregate demand (AD) is what economists call total planned expenditure. In a simple two-sector economy, the ex-ante aggregate demand (AD) for final goods or aggregate expenditure consists of only two components:<br>(i) Ex ante aggregate demand for consumer goods (C), and<br>(ii) Ex ante aggregate demand for investment goods (I).<br>Thus, AD = C + I ………………(i)<br><br>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:<br><br>$AD = C + \bar{I}$ …………………..(ii)<br>Where $\bar{I}$ = constant investment.<br>From the equation (ii), we can infer that, in the short- run, AD depends largely on the aggregate consumption expenditure. | |

| 38. | Q.10b(i) | PYQ May 22 |
|---|---|---|

Calculate Multiplier and Marginal Propensity to Consume (MPC) with the help of following information:

| Particulars | 2020-21 (₹ in Crore) | 2021-22 (₹ in Crore) |
|---|---|---|
| Investment | 1600 | 2000 |
| National Income | 5000 | 6600 |

**Ans.**

**(i) Calculation of Marginal Propensity to Consume (MPC)**

Increase in investment

$\Delta I = 2{,}000 - 1{,}600 = ₹\ 400$ Crore

Increase in National Income

$= \Delta Y = 6{,}600 - 5{,}000$

$= ₹\ 1{,}600$ Crore

**Multiplier** $k = \frac{\Delta y}{\Delta I} = \frac{1{,}600}{400} = \mathbf{4}$

We know that $k = \frac{1}{1 - MPC}$

$4 = \frac{1}{1 - MPC}$

$4(1\text{-}MPC) = 1$

$4\text{-}4MPC = 1$

$3 = 4MPC$

$MPC = \frac{3}{4} = 0.75$

**MPC = 0.75**

| 39. | Q.11b(i) | PYQ May 22 |
|---|---|---|

Following information, relating to an economy of a country, for the current year are as under:

| Particulars | (In Crores ₹) |
|---|---|
| GDP MP | 6550 |
| Gross Investment<br>(Including Business fixed investment, Residential construction investment, Public & Inventory investment) | |
| Government Purchases of goods and services | 1500 |
| Exports | 400 |
| Imports | 350 |
| GNPMP | 6600 |
| Indirect Taxes | 200 |
| Depreciation | 200 |

| | |
|---|---|
| | Find out:<br>(A) Private Final Consumption Expenditure<br>(B) Net Factor Income from Abroad<br>(C) NNPFC or National Income |
| Ans. | **(A) Private Final Consumption Expenditure:**<br>$GDP_{MP}$ = Private Final Consumption expenditure + Government final consumption expenditure + Gross domestic Capital formation + Net Export<br>6,550 = Private Final Consumption expenditure + 1,500 +1,000 + 50<br>Private Final Consumption expenditure = 6550-2550 = **₹ 4000 crores**<br><br>(B) **Net Factor Income from Abroad:**<br>= $GNP_{MP}$ – $GDP_{MP}$<br>= 6,600 – 6,550<br>= **₹ 50 crores**<br><br>(C) $NNP_{FC}$ or National Income:<br>= $GDP_{MP}$ – depreciation + NFIA – NIT<br>= 6,550 – 200 + 50 - 200<br>= **₹ 6,200 crores** |

| 40. | Q.7a | PYQ Nov 22 |
|---|---|---|
| | The equilibrium level of income (Y) of an economy is ₹ 2,000 crores.<br>The autonomous consumption expenditure (a) is equal to ₹ 100 crores and investment expenditure (I) is ₹ 500 crores.<br>You are required to calculate:<br>(i) Consumption expenditure at equilibrium level of National Income.<br>(ii) Marginal Propensity to Consume (MPC) and Marginal Propensity to Save (MPS).<br>(iii) Equilibrium level of income if saving function is S = - 10 + 0.2Y. | |
| Ans. | **(i) Consumption expenditure at equilibrium level:**<br>Y = C + I<br>C = Y-I<br>By putting value, we get<br>= ₹ 2000 - ₹ 500<br>C = ₹ 1500 Crores<br><br>**(ii) MPC and MPS:**<br>C = a + bY<br>1500 = 100 + b × 2000<br>b = 1400 ÷ 2000<br>= 0.7<br>MPC (b) = 0.7<br>MPS = 1 - MPC = 1 - 0.7<br>**MPS = 0.3** | |

| 41. | Q.8b(i) | PYQ Nov 22 |
|---|---|---|

The following data is available for a company:

| Particulars | Amount (in ₹ Crore) |
|---|---|
| Gross Value Added ($GVA_{MP}$) | 2,750 |
| Sales | 3,450 |
| Closing Stock | 750 |
| Interest | 200 |
| Opening Stock | 900 |
| Net indirect taxes | 550 |
| Rent | 310 |
| Mixed income | 380 |
| Compensation to employees | 600 |
| Consumption of fixed capital | 320 |

Based on the above information, compute the following:

(i) Amount of Intermediate Consumption.

(ii) Net Domestic Product at Factor Cost ($NDP_{FC}$),

(iii) Profit of the company

**Ans.**

(i) $GVA_{MP}$ = Sales + Change in Stock – Intermediate Consumption

2750 = 3450 + (750-900)- Intermediate Consumption

2750 = 3300-Intermediate Consumption

Intermediate Consumption = 3300-2750

**Intermediate Consumption= ₹ 550 Crores**

(ii) Net Domestic Product at Factor cost = $NDP_{MP}$ - Net indirect taxes

$NDP_{MP}$ = $GVA_{MP}$ - Consumption of fixed capital

= 2750 – 320 = ₹2430 Crores

**$NDP_{FC}$ =** 2430 – 550 **= ₹1880 crores**

(iii) Operating surplus = Rent + Interest + Profit

Profit = Operating surplus – Rent - Interest

$NDP_{FC}$ = Compensation to employees + Operating surplus + Mixed income

1880 = 600 + Operating surplus + 380

Operating surplus = 1880 – 600 – 380 = ₹900 Crores

Profit = 900 – 310 - 200 = ₹ 390 crores

| 42. | Q.9a(ii) | PYQ Nov 22 |
|---|---|---|
| | "Net Exports" can be negative or positive. How is it significant for the economy of a country? | |
| Ans. | **The Net Exports:** Net exports are the **difference between exports and imports** of a country during the accounting year. It can be positive or negative.<br><br>The net export component of GDP is equal to the value of exports (X) minus the value of imports (M). The gap between exports and imports is also called the trade balance. If a country's exports are larger than its imports, then a country is said to have a trade surplus else it will be trade deficit.<br><br>Net exports are the difference between exports and imports of a country during the accounting year. It can be positive or negative. Export stimulates economic growth by creating jobs which could potentially reduce poverty and augmenting factor incomes and in so doing raising the standard of livelihood and overall demand for goods and services. | |

| 43. | Q.11a(i) | PYQ Nov 22 |
|---|---|---|
| | How are the following transactions treated in National Income Calculation?<br>(A) B sold a used car to C and receive ₹ 80,000. How much of the sale proceeds will be included in National Income calculation?<br>(B) Fees paid to real estate agents and lawyers.<br>(C) Electric power sold to a consumer household. | |
| Ans. | (A) **Sale of used car:** No part of the used car sales proceed of Rs 80,000 will be included in national income calculation because sales of used car represent transfer of existing assets which was proceed during some earlier year and was accounted in the national Income calculation of that year<br>**(B) Fees paid to real estate agents and lawyers:** Fees paid to real estate agents and lawyers represent current production and, therefore, are included in national income.<br>**(C) Electric power sold to a consumer household:** Electric power sold to a consumer does not require any further processing and does not undergo any further transformation before use. Once a final goods has been sold, it passes out of the active economic flow. | |

# CHAPTER 2 - PUBLIC FINANCE

| 1. | Q.2d | MTP Mar 23 |
|---|---|---|
| | **What is government failure?** | |
| **Ans.** | A government failure is said to occur when government intervention in the market creates inefficiency and leads to misallocation of society's scarce resources. The possible sources of this type of government failures are inadequate information, political self-interest, conflicting objectives, bureaucracy, corruption and red tape, and high administrative costs involved in government intervention. Government failure may be relatively inconsequential if it gets restricted to being simply ineffective and therefore the costs of such intervention are limited to the resources wasted for such intervention. Government failure is more serious when such intervention has generated new and serious problems which will have far reaching adverse consequences on the welfare of citizens. Governments should, therefore, identify and evaluate the inefficiencies that may result from market failure and the potential inefficiencies associated with deliberate government policies framed to redress market failure. | |

| 2. | Q.3a | MTP Mar 23 |
|---|---|---|
| | **At the time of recession what Policy government adopt for revenue and expenditure?** | |
| **Ans.** | Government expenditure injects more money into the economy and stimulates demand. On the other hand, taxes reduce the disposable income of people and therefore, reduce effective demand. During recession, in order to ensure income protection, the government increases its expenditure or cuts down taxes or adopts a combination of both so that aggregate demand is kept stable or even boosted up with more money put into the hands of the people. On the other hand, to control high inflation the government cuts down its expenditure or raises taxes. In other words, an expansionary fiscal policy is adopted to alleviate recession and a contractionary fiscal policy is resorted to for controlling high inflation. Generally, government's fiscal policy has a strong influence on the performance of the macro economy in terms of employment, price stability, economic growth, and external balance. | |

| 3. | Q.3b | MTP Mar 23 |
|---|---|---|
| | **Externalities may be unidirectional or reciprocal. Substantiate this Statement with Suitable Example?** | |
| **Ans.** | The unique feature of an externality is that it is initiated and experienced not through the operation of the price system, but outside the market. Since it occurs outside the price mechanism, it has not been compensated for, or in other words it is uninternalized or the cost (benefit) of it is not borne (paid) by the parties. Suppose a workshop creates ear- splitting noise and imposes an externality on a baker who produces smoke and disturbs the workers in the workshop, then this is a case of reciprocal externality. If an accountant who is disturbed by loud music but has not imposed any externality on the singers, then the externality is unidirectional. | |

| 4. | Q.3c | MTP Mar 23 |
|---|---|---|
| | **What is Government Spending Multiplier?** | |
| **Ans.** | Spending multiplier (also known as Keynesian or fiscal policy multiplier) represents the multiple by which GDP increases or decreases in response to an increase and decrease in government expenditures and investment, holding the real money supply constant. Quantitatively, the government spending multiplier is the same as the investment multiplier. It is the reciprocal of the marginal propensity to save (MPS). Higher the MPS, lower the multiplier, and lower the MPS, higher the multiplier. | |

| 5. | Q.3d | MTP Mar 23 |
|---|---|---|
| | **What is crowding out effect?** | |
| **Ans.** | The crowding out view is that a rapid growth of government spending leads to a transfer of scarce productive resources from the private sector to the public sector where productivity might be lower. An increase in the size of government spending during recessions will 'crowd-out' private spending in an economy and lead to reduction in an economy's ability to self-correct from the recession, and possibly also reduce the economy's prospects of long-run economic growth. | |

| 6. | Q.4a | MTP Mar 23 |
|---|---|---|
| | **What is the distinction between Expansionary and Contractionary fiscal Policy?** | |
| **Ans.** | The distinction between Expansionary and Contractionary Policy is as follows: Expansionary fiscal policy is designed to stimulate the economy during the contractionary phase of a business cycle and is accomplished by increasing aggregate expenditures and aggregate demand through an increase in all types of government spending and / or a decrease in taxes. Contractionary fiscal policy is designed to restrain the levels of economic activity of the economy during an inflationary phase by decreasing the aggregate expenditures and aggregate demand through a decrease in all types of government spending and/ or an increase in taxes. | |

| 7. | Q.5c | MTP Mar 23 |
|---|---|---|
| | **What are advantage of Positive Externalities?** | |
| **Ans.** | Since positive externalities promote welfare, governments implement policies that promote positive externalities. When positive externalities are present, government may attempt to solve the problem through corrective subsidies to the producers aimed at either increasing the supply of the good or through corrective subsidies to consumers aimed at increasing the demand for the good. | |

| 8. | Q.3a | MTP April 23 |
|---|---|---|
| | **What is the rationale of government Subsidy?** | |
| **Ans.** | A government subsidy is a market-based approach that changes the price of the product and allows individual consumers to respond to those prices and make their own decisions. A subsidy on a good which has substantial positive externalities would reduce the marginal private costs of production, increase the supply, shift the supply curve to the right, reduce the price and increase the quantity demanded of the subsidised good. A higher | |

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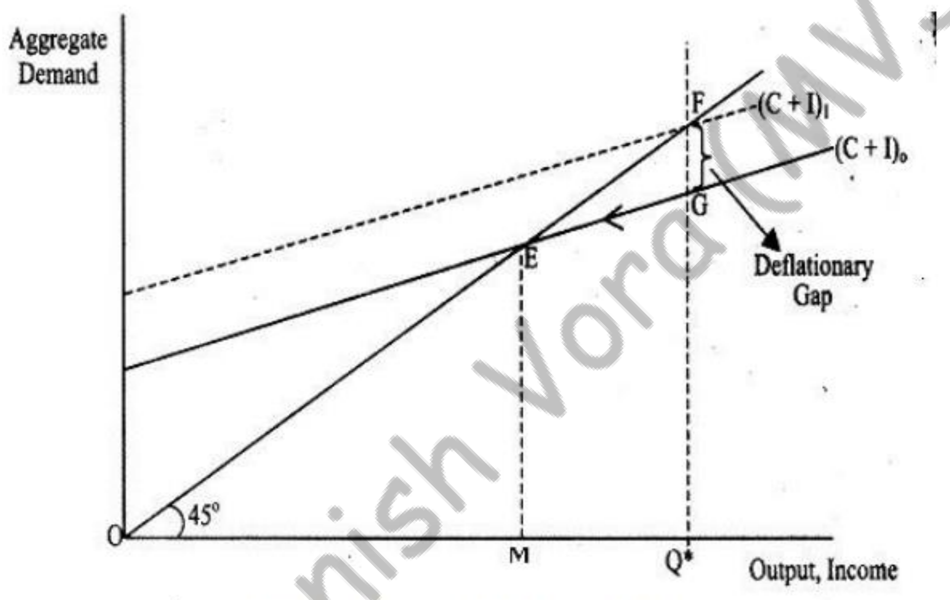
| | output that would equate marginal social benefit and marginal social cost is socially optimal. There are many forms of subsidies given out by the government. Two of the most common types of individual subsidies are welfare payments and unemployment benefits. |

| 9. | Q.3b | MTP April 23 |
|---|---|---|
| | What are the government initiative towards negative externalities? | |
| Ans. | Government initiatives towards negative externalities may be classified as: 1. Direct controls or regulations that openly regulate the actions of those involved in generating negative externalities, and 2. Market-based policies that would provide economic incentives so that the self-interest of the market participants would achieve the socially optimal solution.<br>Direct controls, also known as command solutions, prohibit specific activities that explicitly create negative externalities or require that the negative externality be limited to a certain level. For example, government may limit the amounts of certain pollutants released into water and air by individual firms or make it mandatory to use pollution control devices. Licensing, production quotas and mandates regarding acceptable production processes are other examples of direct intervention by governments. Production, use and sale of many commodities and services are prohibited in our country. Smoking is completely banned in many public places. Stringent rules are in place in respect of tobacco advertising, packaging and labelling etc. | |

| 10. | Q.4b | MTP April 23 |
|---|---|---|
| | What are the main Characteristics of merit goods? | |
| Ans. | Merit goods are goods which are deemed to be socially desirable and therefore the government deems that its consumption should be encouraged. Substantial positive externalities are involved in the consumption of merit goods. Left to the market, only private benefits and private costs would be reflected in the price paid by consumers. This means, compared to what is socially desirable, people would consume inadequate quantities. Examples of merit goods include education, health care, welfare services, housing, fire protection, waste management, public libraries, museum and public parks. | |

| 11. | Q.5b | MTP April 23 |
|---|---|---|
| | What do you understand by Free Rider Problem? | |
| Ans. | A free rider is a person who benefits from something without expending effort or paying for it. In other words, free riders are those who utilize goods without paying for their use. Example is Wikipedia, a free encyclopaedia which faces a free rider problem. Hundreds of millions of people use Wikipedia every month but only a small part of users pay to use it. A large majority of Wikipedia users do not pay to use the site but are able to benefit from the information provided by the website. The free-rider problem occurs when everyone enjoys the benefits of a good without paying for it. | |

| 12. | Q.5d | MTP April 23 |
|---|---|---|
| | What is the Social Cost? | |
| Ans. | The total costs to the society on account of a production or consumption activity. Social costs are private costs borne by individuals directly involved in a transaction together with the external costs borne by third parties not directly involved in the transaction. Social Cost = Private Cost + External Cost. | |

| 13. | Q.2b | MTP Sept 22 |
|---|---|---|
| | Elaborate the Concept of deflationary gap and how this impact the economy? | |
| Ans. | If the aggregate demand is for an amount of output less than the full employment level of output, then we say there is deficient demand. Deflationary gap is thus a measure of the extent of deficiency of aggregate demand, and it causes the economy's income, output, and employment to decline, thus pushing the economy to under- employment equilibrium.  (Deficient Demand - Deflationary Gap) | |



| 14. | Q.2d | MTP Sept 22 |
|---|---|---|
| | Efficiency of market is affected by monopoly power: Comment. | |
| Ans. | The presence of monopoly power affects the efficiency of markets in different degrees leading to under-production and higher prices than would exist under conditions of competition. These distort the choices available to consumers and reduce their welfare. | |

| 15. | Q.3d | MTP Sept 22 |
|---|---|---|
| | Describe the various interventionist measures adopted by the government? | |
| Ans. | Adam Smith is often described as a bold advocate of free markets and minimal governmental activity. However, Smith saw an important resource allocation role for government when he underlined the role of government in national defence, maintenance of justice and the rule of law, establishment and maintenance of highly beneficial public institutions and public works which the market may fail to produce on account of lack of sufficient profits. Since the 1930s, more specifically as a consequence of the great depression, the state's role in the | |

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| | economy has been distinctly gaining in importance, and therefore, the traditional functions of the state as described above, have been supplemented with what is referred to as economic functions (also called fiscal functions or public finance function). While there are differences among different countries in respect of the nature and extent of government intervention in economies, all of them agree on one point that the governments are expected to play a major role in the economy. This comes out of the belief that government intervention will invariably influence the performance of the economy in a positive way. |

| 16. | Q.4c | MTP Sept 22 |
|---|---|---|
| | **What is the market Outcome of Price Ceiling?** | |
| **Ans.** | Price ceilings prevent a price from rising above a certain level. When a price ceiling is set below the equilibrium price, quantity demanded will exceed quantity supplied, and excess demand or shortages will result. For example: maximum prices of food grains and essential items are set by the government during times of scarcity. A price ceiling which is set below the prevailing market clearing price will generate excess demand over supply.<br>A price ceiling will only impact the market if the ceiling is set below the free- market equilibrium price. This is because a price ceiling above the equilibrium price will lead to the product being sold at the equilibrium price. If the ceiling is less than the economic price, the immediate result will be a supply shortage. | |

| 17. | Q.4d | MTP Sept 22 |
|---|---|---|
| | **What is Pump Priming?** | |
| **Ans.** | Pump priming involves a one-shot injection of government expenditure into a depressed economy with the aim of boosting business confidence and encouraging larger private investment. It is a temporary fiscal stimulus in order to set off the multiplier process. The argument is that with a temporary injection of purchasing power into the economy through a rise in government spending financed by borrowing rather than taxes, it is possible for government to bring about permanent recovery from a slump. Pump priming was widely used by governments in the post-war era in order to maintain full employment; however, it became discredited later when it failed to halt rising unemployment and was held responsible for inflation. | |

| 18. | Q.5a | MTP Sept 22 |
|---|---|---|
| | **Define Public good. Why do you consider national defence as a Public good?** | |
| **Ans.** | A public good (also referred to as a collective consumption good or a social good) is defined as one which all individuals enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction from any other individual's consumption of that good. National defence has all characteristics of a public good. It yields utility to people; its consumption is essentially nonrival, non-excludable and collective in nature and is characterized by indivisibility. National defence is available for all individuals whether they pay taxes or not and it is impossible to exclude anyone within the country from consuming and benefiting from it. No direct payment by the consumer is involved in the case of defence. Once it is provided, the add itional resource cost of another person consuming it is zero. Defence also has the unique feature of public good i.e. it does not | |

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| | conform to the settings of market exchange. Though defence is extremely valuable for the well being of the society, left to market, it will not be produced at all or will be under produced. |

| 19. | Q.2d | MTP Oct 22 |
|---|---|---|
| | **What are the reasons for government intervention in the market?** | |
| **Ans.** | Maximizing social welfare is one of the primary and most commonly manifest reasons for government intervention in the market. However, it is also possible that instead of eliminating market distortions, sometimes government intervention may contribute to generate them. Governments should, therefore, identify and evaluate the inefficiencies that may result from market failure and the potential inefficiencies associated with deliberate government policies framed to redress market failure. | |

| 20. | Q.3a | MTP Oct 22 |
|---|---|---|
| | **Why do government gives Subsidies?** | |
| **Ans.** | Subsidy is a form of market intervention by government. It involves the government directly paying part of cost to the producers (or consumers) in order to promote the production (consumption) of goods and services. The aim of subsidy is to intervene with market equilibrium to reduce the costs and thereby the market price of goods and services and encourage increased production and consumption. Major subsidies in India are fertiliser subsidy, food subsidy, interest subsidy, etc. | |

| 21. | Q. 3b | MTP Oct 22 |
|---|---|---|
| | **Environmental pollution is regarded as a source of market failure: Comment.** | |
| **Ans.** | Environmental pollution is regarded as a source of market failure because third parties experience negative effects from this activity in which they did not choose to be involved. The social cost exceeds private cost and if producers do not take into account the externalities, th ere will be overproduction and market failure. | |

| 22. | Q.3c | MTP Oct 22 |
|---|---|---|
| | **What is Tragedy of commons?** | |
| **Ans.** | Economists use the term 'tragedy of the commons' to describe the problem which occurs when rivalrous but non-excludable goods are overused to the disadvantage of the entire universe. For example, everyone has access to a commonly held pasture; there are no rules about sustainable numbers for grazing. The outcome of the individual rational economic decisions of cattle owners would be market failure because these actions result in the degradation, depletion or even destruction of the resource leading to welfare loss for the entire society. | |

| 23. | Q.3d | MTP Oct 22 |
|---|---|---|
| | **Explain the concept of Price Floor?** | |
| **Ans.** | Price floor is defined as an intervention to raise market prices if the government feels the price is too low. In this case, since the new price is higher, the producers benefit. For a | |

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| | price floor to be effective, the minimum price has to be higher than the equilibrium price. For example, many governments intervene by establishing price floors to ensure that farmers make enough money by guaranteeing a minimum price that their goods can be sold for. The most common example of a price floor is the minimum wage. This is the minimum price that employers can pay workers for their labour. |

| 24. | Q.4a | MTP Oct 22 |
|---|---|---|
| | **What is Government Spending Multiplier?** | |
| **Ans.** | Spending multiplier (also known as Keynesian or fiscal policy multiplier) represents the multiple by which GDP increases or decreases in response to an increase and decrease in government expenditures and investment, holding the real money supply constant. Quantitatively, the government spending multiplier is the same as the investment multiplier. It is the reciprocal of the marginal propensity to save (MPS). The higher the MPS, lower the multiplier, and lower the MPS, higher the multiplier. | |

| 25. | Q.4b | MTP Oct 22 |
|---|---|---|
| | **What are the limitation of Fiscal Policy?** | |
| **Ans.** | Fiscal policy suffers from limitations such as limitations in respect of choice of appropria te policy, recognition lag, decision lag, implementation lag, impact lag, inappropriate timing, difficulties of forecasting due to uncertainties, possible conflicts between different objectives, possibility of generating disincentives, practical difficulty to reduce government expenditures and the possibility of certain fiscal measures replacing private spending or crowding out private spending. | |

| 26. | Q.1b | RTP May 23 |
|---|---|---|
| | **What are the allocation instruments by which government can influence resource allocation in the economy?** | |
| **Ans.** | A variety of allocation instruments are available by which governments can influence resource allocation in the economy. For example,<br>• government may directly produce an economic good<br>• government may influence private allocation through incentives and disincentives<br>• government may influence allocation through its competition policies, merger policies etc. which affect the structure of industry and<br>• governments' regulatory activities such as licensing, controls, minimum wages, and directives on location of industry influence resource allocation.<br>• government sets legal and administrative frameworks, and<br>• any mixture of intermediate methods may be adopted by governments | |

| 27. | Q.2b | RTP May 23 |
|---|---|---|
| | **What is lemon Problem in Market Failure?** | |
| **Ans.** | When dealing with problems of asymmetric information, the most frequently cited and studied example in Economics is the one developed by George Akerlof in relation to the used car market, which distinguishes cars classified as good from those defined as "lemons" (poor quality vehicles). The owner of a car knows much more about its quality than | |

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| | anyone else. While placing it for sale, he may not disclose all that he knows about the mechanical defects of the vehicle. Based on the probability that the car on sale is a 'lemon', the buyers' willingness to pay for any particular car will be based on the 'average quality' of used cars. Not knowing the honesty of the seller means, the price offered for the vehicle is likely to be less than that of a good car, to account for this risk. However, anyone who sells a 'lemon' (an unusually poor car) stands to gain. |

| 28. | Q.3a | RTP May 23 |
|---|---|---|
| | **How Public Debt is used as an Instrument of Fiscal Policy?** | |
| **Ans.** | A rational policy of public borrowing and debt repayment is a potent weapon to fight inflation and deflation. In the case of market loans, the government issues treasury bills and government securities of varying denominations and duration which are traded in debt markets. For financing capital projects, long-term capital bonds are floated and for meeting short-term government expenditure, treasury bills are issued.<br><br>The small savings represent public borrowings, which are not negotiable and are not bought and sold in the market. In India, various types of schemes are introduced for mobilising small savings e.g., National Savings Certificates, National Development Certificates, etc. Borrowing from the public through the sale of bonds and securities curtails the aggregate demand in the economy. Repayments of debt by governments increase the availability of money in the economy and increase aggregate demand. | |

| 29. | Q.3b | RTP May 23 |
|---|---|---|
| | **What is Compensatory Spending?** | |
| **Ans.** | Compensatory spending is said to be resorted to when the government spending is deliberately carried out with the obvious intention to compensate for the deficiency in private investment. | |

| 30. | Q.3d | RTP May 23 |
|---|---|---|
| | **What is the Rationale of the Stabilization Function of the Government?** | |
| **Ans.** | Stabilization function is one of the key functions of fiscal policy and aims at eliminating macroeconomic fluctuations arising from suboptimal allocation. The stabilization function is concerned with the performance of the aggregate economy in terms of labour employment and capital utilization, overall output and income, general price levels, economic growth, and balance of international payments. | |

| 31. | Q.2b | RTP Nov 22 |
|---|---|---|
| | **Does government intervention always result in correcting market failure?** | |
| **Ans.** | We cannot be sure whether the government interventions would be effective or whether it would make the functioning of the economy less efficient. Government failures where government intervention in the economy to correct a market failure creates inefficiency and leads to a misallocation of scarce resources occur very often. Government failure occurs when:<br>• intervention is ineffective causing wastage of resources expended for the intervention | |

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| | • intervention produces fresh and more serious problems<br>There are costs and benefits associated with any Government intervention in a market, and it is important that policy makers consider all of the costs and benefits of a policy intervention. |

| 32. | Q.3d | RTP Nov 22 |
|---|---|---|
| | **What type of Policy is preferable during the time of recession?** | |
| Ans. | A recession is said to occur when overall economic activity declines, or in other words, when the economy 'contracts. A recession sets in with a period of declining real income, as measured by real GDP simultaneously with a situation of rising unemployment. If an economy experiences a fall in aggregate demand during a recession, it is said to be in a demand-deficient recession. Due to decline in real GDP, the aggregate demand falls and therefore, lesser quantity of goods and services will be produced. To combat such a slump in overall economic activity, the government can resort to expansionary fiscal policies. | |

| 33. | Q.4b | RTP Nov 22 |
|---|---|---|
| | **What is meant by crowding out?** | |
| Ans. | The crowding out view is that a rapid growth of government spending leads to a transfer of scarce productive resources from the private sector to the public sector where productivity might be lower. An increase in the size of government spending during recessions will 'crowd-out' private spending in an economy and lead to reduction in an economy's ability to self-correct from the recession, and possibly also reduce the economy's prospects of long-run economic growth. | |

| 34. | Q.5a | RTP Nov 22 |
|---|---|---|
| | **What is the Characteristic of Private Goods?** | |
| Ans. | Most of the goods produced and consumed in an economy are private goods. A few examples are food items, clothing, movie ticket, television, cars, houses etc.<br>• Private goods refer to those goods that yield utility to people. Since they are scarce anyone who wants to consume them must purchase them.<br>• Owners of private goods can exercise private property rights and can prevent others from using the good or consuming their benefits.<br>• Consumption of private goods is 'rivalrous' that is the purchase and consumption of a private good by one individual prevents another individual from consuming it.<br>• Private goods are 'excludable' i.e., it is possible to exclude or prevent consumers who have not paid for them from consuming them or having access to them<br>• Private goods do not have the free-rider problem. This means that private goods will be available to only those persons who are willing to pay for them. | |

| 35. | Q.7c | PYQ May 22 |
|---|---|---|
| | **Comment on the role of Government intervention for equitable distribution.** | |
| Ans. | **Role of Government Intervention for Equitable Distribution:** A major function of the present-day governments therefore involves changing the pattern of distribution of income, wealth, and opportunities from what the market would put forward to a more | |

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| | socially optimal and egalitarian one. Governments can redistribute either through the expenditure side or through the revenue side of the budget. On the expenditure side, governments may provide free or subsidized education, healthcare, housing, food, and basic goods etc. to deserving people. On the revenue side, redistribution is done through progressive taxation.<br>Inequality and the resulting loss of social welfare is sought to be tackled by government through an appropriately framed tax and transfer policy. This involves progressive taxation combined with provision of subsidy to low- income households. Proceeds from progressive taxes may be used to finance public services, especially those such as public housing, which particularly benefit low-income households. Few examples are supply of essential food grains at highly subsidized prices to BPL households, free or subsidised education, healthcare, housing, rations, and basic goods etc. to the deserving people. |

| 36. | Q.8a(i) | PYQ May 22 |
|---|---|---|
| | **Differentiate between Non-Discretionary and discretionary Fiscal policy.** | |

**Ans.** Distinction between Non-Discretionary and Discretionary Fiscal Policy

| S. No. | Non-Discretionary Fiscal Policy | Discretionary Fiscal Policy |
|---|---|---|
| 1 | These are called automatic Stabilizers. Changes tend to occur automatically without any explicit action by the Government. | These are deliberate policy action by the Government to change the level of expenditure and taxes in order to influence the level of National output employment and prices. |
| 2 | Personal income tax, corporate income taxes and transfer payments by Government constitute the major examples. | Specific export subsidies and concessions are examples. |
| 3 | Nondiscretionary fiscal policy is that set of policies that are built into the system to stabilize the economy when growth is either too fast or too slow. | Discretionary fiscal policy consists of actions taken at the time of a problem to alter the economy of the moment. Thus, the aim can be anti-cyclical (decrease) or pro cyclical (increase). |
| 4 | Non-Discretionary Fiscal Policy ensures self-correcting fiscal response. | Discretionary policy usually implies implementation lags and is not automatically reversed when economic conditions change. |

**Alternatively:**

Discretionary fiscal policy refers to deliberate policy actions on the part of the government to change the levels of expenditure and taxes to influence the level of national output, employment, and prices. Non-discretionary fiscal policy or automatic stabilizers are part of the structure of the economy and are 'built-in' fiscal mechanisms that operate automatically to reduce the expansions and contractions of the business cycle. Changes in fiscal policy do not always require explicit action by government. In most economies,

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| | changes in the level of taxation and level of government spending tend to occur automatically. These are dependent on and are determined by the level of aggregate production and income, such that the instability caused by business cycle is automatically dampened without any need for discretionary policy action.<br><br>However, automatic stabilizers that depend on the level of economic activity alone would not be sufficient to correct instabilities. The government needs to resort to discretionary fiscal policies. Discretionary fiscal policy for stabilization refers to deliberate policy actions on the part of government to change the levels of expenditure, taxes to influence the level of national output, employment, and prices. Governments influence the economy by changing the level and types of taxes, the extent and composition of spending, and the quantity and form of borrowing. |

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| **37.** | **Q.9a(i)** | **PYQ May 22** |
| | **Explain 'Global Public goods' with examples.** | |
| **Ans.** | **Global Public Goods**<br>Global public goods are those public goods with benefits/costs that potentially extend to everyone in the world. These goods have widespread impact on different countries and regions, population groups and generations throughout the entire globe.<br>Examples of Global Public Goods may be:<br>• Final public goods which are 'outcomes' such as ozone layer preservation or prevention of climate change and bio-diversity.<br>• Intermediate public goods, which contribute to the provision of final public goods e.g., international health regulations for communicable diseases including HIV/AIDS, tuberculosis, malaria and avian influenza.<br>• International trade, international financial architecture and global knowledge for development.<br>The World Bank identifies five areas of global public goods which it seeks to address: namely, the environmental commons, communicable diseases, international trade, international financial architecture, and global knowledge for development. The distinctive characteristic of global public goods is that there is no mechanism (either market or government) to ensure an efficient outcome. | |

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| **38.** | **Q.10a(i)** | **PYQ May 22** |
| | **What are the common objectives of fiscal policy?** | |
| **Ans.** | **Common Objectives of Fiscal Policy**<br>Fiscal policy is in the nature of a demand-side policy. An economy which is producing at full-employment level does not require government action in the form of fiscal policy. The most common objectives of fiscal policy are:<br>▪ achievement and maintenance of full employment,<br>▪ maintenance of price stability,<br>▪ acceleration of the rate of economic growth and development, and<br>▪ equitable distribution of income and wealth. | |

| 39. | Q.11a(ii) | PYQ May 22 |
|---|---|---|
| | Identify the market outcomes for each of the following situations:<br>(A) Playing of loud music at night resulting in inability to sleep.<br>(B) Wearing of mask during covid-19 pandemic | |
| Ans. | **Situations and Market outcomes:**<br>(A) Playing of loud music at night resulting in inability to sleep<br>**Market Outcome:** **Negative** Consumption externality, over production.<br>(B) Wearing of mask during COVID-19 pandemic<br>**Market Outcome:** **Positive** consumption externality as it prevents others from getting infected | |

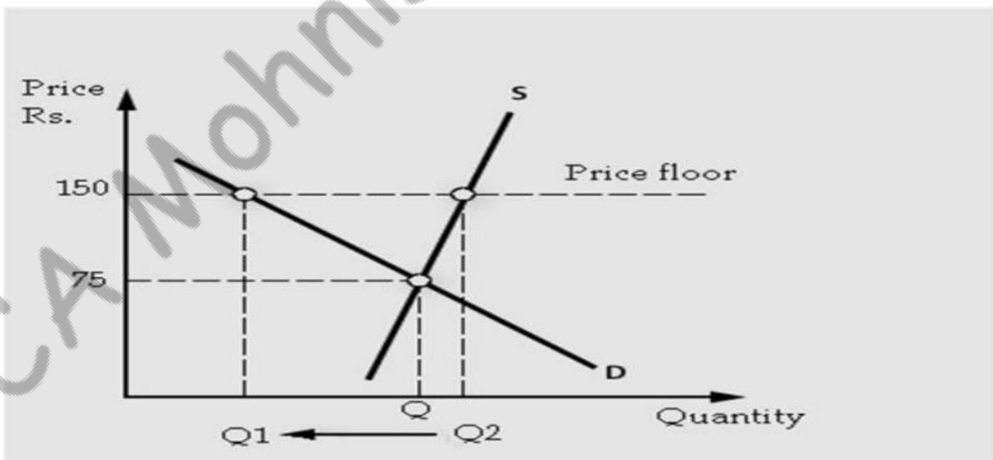
| 40. | Q.7d | PYQ Nov 22 |
|---|---|---|
| | What is the difference between price ceiling and price floor? | |

**Ans.**

**Price Ceiling**: When prices of certain essential commodities rise excessively, government may resort to controls in the form of price ceilings for making a resource or commodity available to all at reasonable prices. For example: maximum prices of food grains and essential items are set by government during times of scarcity. A price ceiling which is set below the prevailing market clearing price will generate excess demand over supply.

**Price Floor**: Government usually intervenes in many primary markets which are subject to extreme as well as unpredictable fluctuations in price. For example, in India, in the case of many crops the government has initiated the Minimum Support Price (MSP) programme as well as procurement by government agencies at the set support prices.

The objective is to guarantee steady and assured incomes to farmers. In case the market price falls below the MSP, then the guaranteed MSP will prevail. The following diagram will illustrate the effects of a price floor.




Market Outcome of Minimum Support Price

When price floors are set above market clearing price, suppliers are encouraged to over-supply and there would be an excess of supply over demand. At price ` 150/ which is much above the market determined equilibrium price of ` 75, the market demand is only Q1, but the market supply is Q2.

| 41. | Q.8a(ii) | PYQ Nov 22 |
|---|---|---|
| | **One of the biggest problem with using discretionary policy to counteract fluctuations is the different types of lags involved in fiscal policy action. What are these lags?** | |
| Ans. | **Lags in fiscal policy:**<br>One of the biggest problems with using discretionary fiscal policy to counteract fluctuations is the different types of lags involved in fiscal-policy action. There are significant lags are:<br>**Recognition lag:** The economy is a complex phenomenon, and the state of the macro-economic variables is usually not easily comprehensible. Just as in the case of any other policy, the government must first recognize the need for a policy change.<br>**Decision lag**: Once the need for intervention is recognized, the government has to evaluate the possible alternative policies. Delays are likely to occur to decide on the most appropriate policy.<br>**Implementation lag:** even when appropriate policy measures are decided on, there are possible delays in bringing in legislation and implementing them.<br>**Impact lag:** impact lag occurs when the outcomes of a policy are not visible for some time | |

| 42. | Q.9b(ii) | PYQ Nov 22 |
|---|---|---|
| | **Write down the name of fiscal function of the Government in Economic System, for the following cases:**<br>**(a) Government imposes higher taxes on tobacco products in Union Budget.**<br>**(b) Government scheme providing free ration to BPL families.**<br>**(c) Government providing subsidy to farmers in purchasing of Urea for agricultural purpose.**<br>**(d) Increase in Government expenditure in the time of recession.** | |
| Ans. | Fiscal Functions of Government<br>(i) Allocation function<br>(ii) Redistribution/distribution function<br>(iii) Allocation function<br>(iv) Stabilization function | |

| 43. | Q.10a(ii) | PYQ Nov 22 |
|---|---|---|
| | **Mention the name of the externalities (along with reason in brief) covered in the following acts:**<br>**(i) A Road Construction Company provides training to its employees to learn latest technology for durable road construction.**<br>**(ii) People taking COVID Booster Dose happily.** | |
| Ans. | (i) As an example of **positive production externality** received in production, we can cite the case of a firm which offers training to its employees for increasing their skills. The firm generates positive benefits on other firms when they hire such workers as they change their jobs.<br>(ii) A **positive consumption externality** initiated in consumption that confers external benefits on others may be received in consumption or in production. For example, if people taking COVID Booster Dose happily against contagious diseases, they | |

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| | would confer a social benefit to others as well by preventing others from getting infected. |

| 44. | Q.11b(i) | PYQ Nov 22 |
|---|---|---|
| | **Discuss with examples the major aspects of market failures.** | |
| Ans. | **Major aspects of market failures**<br>There are two aspects of market failures namely, demand-side market failures and supply side market failures. Demand- side market failures are said to occur when the demand curves do not take into account the full willingness of consumers to pay for a product.<br><br>For example, though we experience the benefit, none of us will be willing to pay to view a wayside fountain because we can view it without paying. Supply-side market failures happen when supply curves do not incorporate the full cost of producing the product. For example, a thermal power plant that uses coal may not have to include or pay completely for the costs to the society caused by fumes it discharges into the atmosphere as part of the cost of producing electricity. | |

# CHAPTER 3 - Money Market

| | | |
|---|---|---|
| **1.** | **Q.5b** | **MTP Mar 23** |
| | **The speculative demand for money and interest are inversely related. Comment.** | |
| **Ans.** | So long as the current rate of interest is higher than the critical rate of interest, a typical wealthholder would hold in his asset portfolio only government bonds, and if the current rate of interest is lower than the critical rate of interest, his asset portfolio would consist wholly of cash. When the current rate of interest is equal to the critical rate of interest, a wealth-holder is indifferent to holding either cash or bonds | |

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|---|---|---|
| **2.** | **Q.3d** | **MTP April 23** |
| | **What is Market Stabilization Scheme?** | |
| **Ans.** | This instrument for monetary management was introduced in 2004 following a MoU between the Reserve Bank of India (RBI) and the Government of India (GoI) with the primary aim of aiding the sterilization operations of the RBI. (Sterilization is the process by which the monetary authority sterilizes the effects of significant. )<br>Foreign capital inflows on domestic liquidity by off-loading parts of the stock of government securities held by it). Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills. Under this scheme, the Government of India borrows from the RBI (such borrowing being additional to its normal borrowing requirements) and issues treasury-bills/dated securities for absorbing excess liquidity from the market arising from large capital inflows. | |

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| **3.** | **Q.4c** | **MTP April 23** |
| | **What is the relationship between Interest rate and demand for money?** | |
| **Ans.** | The speculative motive reflects people's desire to hold cash in order to be equipped to exploit any attractive investment opportunity requiring cash expenditure. According to Keynes, people demand to hold money balances to take advantage of the future changes in the rate of interest, which is the same as future changes in bond prices. It is implicit in Keynes theory, that the 'rate of interest', i, is really the return on bonds. | |

| | | |
|---|---|---|
| **4.** | **Q.5d** | **MTP April 23** |
| | **What is Credit Money?** | |
| **Ans.** | Credit money' refers to the fraction of money supply created by commercial banks in the process of borrowing and lending transactions with the public. | |

| | | |
|---|---|---|
| **5.** | **Q.2c** | **MTP Sept 22** |
| | **Calculate M3 from the following data:** | |

| Components | ₹ in Crore |
|---|---|
| Currency with the Public | 15,000 |
| Demand Deposit with Banks | 12,000 |
| Time Deposit with Banks | 10,000 |
| Other Deposit with Reserve bank | 70,000 |

**Ans.**

M3 = M1 + Time deposit with banking system
= Currency with the Public + Demand deposit with Banks + Other deposit with banks + Time deposit with banking system
= 15000+ 12000+ 70000+10000
= 107000 crores

**6.** **Q.3a** **MTP Sept 22**

**What are the different motive for holding cash according to Keynes?**

**Ans.**

According to Keynes, people hold money (M) in cash for three motives:

(i) Transactions motive,
(ii) Precautionary motive, and
(iii) Speculative motive.

The transaction motive for holding cash is directly related to the level of in - come and relates to 'the need for cash for the current transactions for personal and business exchange.

The amount of money demanded under the precautionary motive is to meet unforeseen and unpredictable contingencies involving money payments and depends on the size of the income, prevailing economic as well as political conditions and personal characteristics of the individual such as optimism/ pessimism, farsightedness etc.

The speculative motive reflects people's desire to hold cash in order to be equipped to exploit any attractive investment opportunity requiring cash expenditure. The speculative demand for money and interest are inversely related.

**7.** **Q.3c** **MTP Sept 22**

**What is the relationship between money multiplier and money supply?**

**Ans.**

If the central bank of a country wants to stimulate economic activity it does so by infusing liquidity into the system. Let us take the example of open market operations (OMO) by central banks. Purchase of government securities injects high powered money (monetary base) into the system. Assuming that banks do not hold excess reserves and people do not hold more currency than before, and also that there is demand for loans from businesses, the credit creation process by the banking system in the country will create money to the tune of

$\Delta$Money Supply = 1/ R X $\Delta$ Reserve

The effect of an open market sale is very similar to that of open market purchase, but in the opposite direction. In other words, an open market purchase by central bank will reduce the reserves and thereby reduce the money supply.

| 8. | Q.4a | MTP Sept 22 |
|---|---|---|
| | **How do changes in Statutory liquidity ratio impact the economy?** | |
| **Ans.** | The SLR is also a powerful tool for controlling liquidity in the domestic market by means of manipulating bank credit. Changes in the SLR chiefly influence the availability of resources in the banking system for lending. A rise in the SLR which is resorted to during periods of high liquidity, tends to lock up a rising fraction of a bank's assets in the form of eligible instruments, and this reduces the credit creation capacity of banks. A reduction in the SLR during periods of economic downturn has the opposite effect. The SLR requirement also facilitates a captive market for government securities. | |

| 9. | Q.5b | MTP Sept 22 |
|---|---|---|
| | **What role does market Stabilization Scheme (MSS) Play in our Economy?** | |
| **Ans.** | This instrument for monetary management was introduced in 2004 following a MoU between the Reserve Bank of India (RBI) and the Government of India (GoI) with the primary aim of aiding the sterilization operations of the RBI. (Sterilization is the process by which the monetary authority sterilizesthe effects of significant foreign capital inflows on domestic liquidity by off-loading parts of the stock of government securities held by it). Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills. Under this scheme, the Government of India borrows from the RBI (such borrowing being additional to its normal borrowing requirements) and issues treasury-bills/dated securities for absorbing excess liquidity from the market arising from large capital inflows. | |

| 10. | Q.4c | MTP Oct 22 |
|---|---|---|
| | **What is the effect of Government Expenditure on Money Supply?** | |
| **Ans.** | Whenever the central and the state governments' cash balances fall short of the minimum requirement, they are eligible to avail of a facility called Ways and Means Advances (WMA)/overdraft (OD) facility. When the Reserve Bank of India lends to the governments under WMA /OD, it results in the generation of excess reserves (i.e., excess balances of commercial banks with the Reserve Bank). This happens because when the government incurs expenditure, it involves debiting the government balances with the Reserve Bank and crediting the receiver (for e.g., salary account of government employee) account with the commercial bank. The excess reserves thus created can potentially lead to an increase in money supply through the money multiplier process. | |

| 11. | Q.4d | MTP Oct 22 |
|---|---|---|
| | **Calculate Narrow Money (M1) from the following data :** | |

| | |
|---|---|
| Currency with public | 80000 cr |
| Demand Deposits with Banking System | 100000 cr |
| Time Deposits with Banking System | 200000 cr |
| Other Deposits with RBI | 250000 cr |
| Saving Deposits of Post office saving banks | 50000 cr |

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| **Ans.** | M1 = Currency with public + Demand Deposits with Banking System + Other Deposits with the RBI<br>= 80000 crore + 100000 crores + 250000 crores<br>= 430000 cr |

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| **12.** | **Q.4c** | **RTP May 23** |
| | **What is the motive for Speculative demand for money?** | |
| **Ans.** | The speculative motive reflects people's desire to hold cash in order to be equipped to exploit any attractive investment opportunity requiring cash expenditure. According to Keynes, people demand to hold money balances to take advantage of the future changes in the rate of interest, which is the same as future changes in bond prices. It is implicit in Keynes theory, that the 'rate of interest', ***i***, is really the return on bonds. Keynes assumed that that the expected return on money is zero, while the expected returns on bonds are of two types, namely:<br>(i) the interest payment<br>(ii) the expected rate of capital gain. | |

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|---|---|---|
| **13.** | **Q.4d** | **RTP May 23** |
| | **What is Market Stabilisation Scheme?** | |
| **Ans.** | This instrument for monetary management was introduced in 2004 following a MoU between the Reserve Bank of India (RBI) and the Government of India (GoI) with the primary aim of aiding the sterilization operations of the RBI. (Sterilization is the process by which the monetary authority sterilizes the effects of significant. foreign capital inflows on domestic liquidity by off-loading parts of the stock of government securities held by it). Surplus liquidity of a more enduring nature arising from large capital inflows is absorbed through sale of short-dated government securities and treasury bills. Under this scheme, the Government of India borrows from the RBI (such borrowing being additional to its normal borrowing requirements) and issues treasury-bills/dated securities for absorbing excess liquidity from the market arising from large capital inflows | |

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| **14.** | **Q.5b** | **RTP May 23** |
| | **What are the determinant of money supply?** | |
| **Ans.** | There are two alternate theories in respect of determination of money supply. According to the first view, money supply is determined exogenously by the central bank. The second view holds that the money supply is determined endogenously by changes in the economic activities which affect people's desire to hold currency relative to deposits, rate of interest, etc. The current practice is to explain the determinants of money supply based on 'money multiplier approach' which focuses on the relation between the money stock and money supply in terms of the monetary base or high-powered money. The monetary base is the sum of currency in circulation and bank reserves. This approach holds that total supply of nominal money in the economy is determined by the joint behavior of the central bank, the commercial banks and the public. | |

| 15. | Q.5c | RTP May 23 |
|---|---|---|
| | **What is CRR and its impact on Money Supply?** | |
| **Ans.** | Cash Reserve Ratio (CRR)refers to the fraction of the total net demand and time liabilities (NDTL) of a scheduled commercial bank in India which it should maintain as cash deposit with the Reserve Bank. Higher the CRR, lower the credit creation capacity of banks. Reduce CRR during deflation- - banks to expand credit and increase the supply of money available in the economy- increase the CRR to contain credit expansion during – inflation. | |

| 16. | Q.5d | RTP May 23 |
|---|---|---|
| | **What is Open market Operation?** | |
| **Ans.** | Open Market Operations (OMO) is a general term used for market operations conducted by the Reserve Bank of India by way of sale/ purchase of Government securities to/ from the market with an objective to adjust the rupee liquidity conditions in the market on a durable basis. | |

| 17. | Q.2c(i) | RTP Nov 22 |
|---|---|---|
| | **Calculate Narrow Money (M1) from the following data.** | |

| | |
|---|---|
| Currency with Public | ₹ 10000 Cr |
| Demand deposit with banking system | ₹ 500000Cr |
| Other deposits with RBI | ₹ 200000Cr |
| Time deposits with banking system | ₹ 250000 Cr |
| Saving Deposits of Post office Saving banks | ₹ 300000 Cr |

**Ans.** M1 = Currency with public + Demand deposits with banking system + Other Deposits with the RBI

= 10000 + 500000 + 200000

= ₹ 7,10,000 Cr

| 18. | Q.3c | RTP Nov 22 |
|---|---|---|
| | **How changes in high powered money and currency ratio influence the money supply in an economy?** | |
| **Ans.** | The excess reserves (ER) which are funds that a bank keeps back beyond what is required by regulation form a very important determinant of money supply. The additional units of high-powered money that goes into 'excess reserves' of the commercial banks do not lead to any additional loans, and therefore, these excess reserves do not lead to creation of money. Therefore, if the central bank injects money into the banking system and these are held as excess reserves by the banking system, there will be no effect on deposits or currency and hence no effect on money supply. | |

| 19. | Q.4a | RTP Nov 22 |
|---|---|---|
| | **Distinguish between the Cambridge and classical version of quantity theory of money?** | |
| **Ans.** | The demand for money was primarily determined by the need to conduct transactions which will have a positive relationship to the money value of aggregate expenditure. Since | |

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| | the latter is equal to money national income, the Cambridge money demand function is stated as:<br>Where **Md = k PY**<br>Md = is the demand for money balances,<br>Y = real national income<br>P = average price level of currently produced goods and services<br>PY = nominal income<br>K = proportion of nominal income (PY) that people want to hold as cash balances.<br>The term 'k' in the above equation is called 'Cambridge k' is a parameter reflecting economic structure and monetary habits, namely the ratio of total transactions to income and the ratio of desired money balances to total transactions. The equation above explains that the demand for money (M) equals k proportion of the total money income.<br><br>Fisher's version, also termed as 'equation of exchange' or 'transaction approach' is formally stated as follows<br>MV = PT<br>Where,<br>M = the total amount of money in circulation (on an average) in an economy<br>V = transactions velocity of circulation i.e. the average number of times across all transactions a unit of money (say Rupee) is spent in purchasing goods and services<br><br>P = average price level (P = MV/T)<br>T = the total number of transactions. |

| | | |
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| **20.** | **Q.5c** | **RTP Nov 22** |
| | **What determine the size of money multiplier?** | |
| **Ans.** | The money multiplier is the reciprocal of the reserve ratio. Deposits, unlike currency held by people, keep only a fraction of the high-powered money in reserves and the rest is lent out and culminate in money creation. If R is the reserve ratio in a country for all commercial banks, then each unit of (say Rupee) money reserves generate 1/R money. Therefore, for any value of R, the Money Multiplier is 1/R For example, if R = 10%, the value of money multiplier will be 10. If the reserve ratio is only 5 %, then money multiplier is 20. Thus, the higher the reserve ratio, the less of each deposit banks loan out, and the smaller the money multiplier. | |

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| **21.** | **Q.5d** | **RTP Nov 22** |
| | **Define Narrow Money?** | |
| **Ans.** | M1(narrow money) is defined as the sum of currency held by the public demand deposits of the banks and other deposits with the RBI. Banks include commercial and cooperative banks. | |

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| **22.** | **Q.7d** | **PYQ May 22** |
| | **Describe the precautionary motive for money.** | |
| **Ans.** | **Precautionary Motive for Money:** Many unforeseen and unpredictable contingencies involving money payments occur in our day-to-day life. Individuals as well as businesses | |

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| | keep a portion of their income to finance such unanticipated expenditures. 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. Keynes regarded the precautionary balances just as balances under transactions motive as income elastic and by itself not very sensitive to rate of interest.<br>The sum of the transaction and precautionary demand, and the speculative demand, is the total demand for money. An increase in income increases the transaction and precautionary demand for money and a rise in the rate of interest decreases the demand for speculative demand money. |

| 23. | Q.8b(ii) | PYQ May 22 |
|---|---|---|
| | **What will be the total money credit created by the commercial banking system for an initial deposit of ₹ 500 if the required reserve ratio is 0.04, 0.06 and 0.10 percent respectively. Compute credit multiplier.** | |
| Ans. | **Credit multiplier** $= \dfrac{1}{\text{Required Reserve Ratio}}$<br>Credit multiplier when RRR is 0.04 = **25**<br>Credit multiplier when RRR is 0.06 = **16.67**<br>Credit multiplier when RRR is 0.10 = **10**<br>**Credit Creation** = Initial Deposit x Credit Multiplier<br>Credit creation $= 500 \times \dfrac{1}{0.04} = \mathbf{12{,}500}$<br>Credit creation $= 500 \times \dfrac{1}{0.06} = \mathbf{8{,}333.33}$<br>Credit Creation $= 500 \times \dfrac{1}{0.10} = \mathbf{5{,}000}$ | |

| 24. | Q.9b(i) | PYQ May 22 |
|---|---|---|
| | **Calculate the volume of Transaction:**<br>**Price = 105**<br>**Velocity of money = 4.2**<br>**Money supply 4500 billion**<br>**What will be the outcome if volume of transaction increases to 240?** | |

| | |
|---|---|
| Ans. | **Calculation of Volume of Transaction**<br>MV = PT<br>4500 × 4.2 = 105 × T<br>**T =** (4500 x 4.2) / 105 = **180**<br>Now if volume of transaction increase to 240 then-<br>4500 × v = 105 × 240<br>**V** = $\frac{105 \times 240}{4,500}$ = **5.6** |

| | | |
|---|---|---|
| 25. | Q.10a(ii) | PYQ May 22 |
| | State the nature of the monetary policy for the following actions taken by the RBI of the country:<br>(A) Reduction in the cash reserve ratio.<br>(B) Selling of securities in the open market.<br>(C) Increase of repo rate by 50 base point.<br>(D) Increase in the supply of currency and coins. | |
| Ans. | Nature of Monetary Policy | |

| | | Nature of Monetary Policy |
|---|---|---|
| A | Reduction in cash reserves ratio. | Expansionary |
| B | Selling of securities in the open market. | Contractionary |
| C | Increase of repo rate by 50 base point. | Contractionary |
| D | Increase in the supply of currency and coins. | Expansionary |

| | | |
|---|---|---|
| 26. | Q.11a(i) | PYQ May 22 |
| | The monetary authority of an economy has provided the following data: | |

| *Particulars* | *₹ in Crore* |
|---|---:|
| *Notes in Circulation* | *2,42,09,645* |
| *Rupee Coin in Circulation* | *3,25,572* |
| *Small Coins in Circulation* | *7,434* |
| *Post Office Saving Bank Deposits* | *14,17,868* |
| *Cash in Hand with banks* | *9,75,635* |
| *Deposit Money of the Public* | *1,77,61,992* |
| *Demand Deposited with banks* | *1,73,76,925* |
| *Other Deposits with Reserve Bank* | *3,85,074* |
| *Total Post Office Deposits* | *1,48,966* |
| *Time Deposits with Banks* | *17,86,969* |

You are required to calculate (i) M1; and (ii) M2.

| | |
|---|---|
| Ans. | Calculation of M1 and M2 |

| | |
|---|---|
| | M1 = (Notes in Circulation + Rupee coin in circulation + small coins in circulation – cash in hands with banks) + demand deposit with bank + other deposit with RBI<br>= 2,42,09,645 + 3,25,572 + 7,434 - 9,75,635 + 1,73,76,925 + 3,85,074<br>= **₹ 4,13,29,015 Crores**<br>M2 = M1 + Post Office Savings Bank Deposits<br>= 4,13,29,015 + 14,17,868<br>= **₹ 4,27,46,883 Crores** |

| | | |
|---|---|---|
| **27.** | **Q.7c** | **PYQ Nov 22** |
| | **Define 'Money Multiplier'. Use of e-wallets is increasing at fast pace nowadays. How this enhanced use of e-wallets is affecting money multiplier and money supply?** | |
| **Ans.** | **Money multiplier:**<br>Money multiplier ***m*** is defined as a **ratio that relates the changes in the money supply to a given change in the monetary base**. It is the ratio of the stock of money to the stock of high-powered money. It denotes by how much the money supply will change for a given change in high-powered money.<br>**Money multiplier (m) = Money Supply / Monetary base**<br>**E wallet** will affect the money supply in the real world. People hold less cash and more deposits thus reducing the currency-deposit ratio; increasing the money multiplier causing the money supply to increase. | |

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| **28.** | **Q.9a(i)** | **PYQ Nov 22** |
| | **Explain the operation of Cash Reserve Ratio.** | |
| **Ans.** | **Operation of Cash Reserve Ratio (CRR):**<br>Cash Reserve Ratio (CRR) refers to the **average daily balance that a bank is required to maintain with the Reserve Bank of India** as a share of its total net demand and time liabilities (NDTL).<br>Higher the CRR with the RBI, lower will be the liquidity in the system and vice versa. During slowdown in the economy, the RBI reduces the CRR in order to enable the banks to expand credit and increases the supply of money available in the economy. In order to contain credit expansion during period's high inflation, the RBI increases the CRR. | |

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| **29.** | **Q.10b(i)** | **PYQ Nov 22** |
| | **What do you understand by "Liquidity Adjustment Facility (LAF)"?** | |
| **Ans.** | **Liquidity Adjustment Facility (LAF):** In line with the financial sector reforms, the system of sector-specific refinance schemes (except export credit refinance scheme) was withdrawn. From June 2000, the RBI has introduced Liquidity Adjustment Facility (LAF).<br>The LAF consists of overnight as well as term repo auctions. The aim of term repo is to help develop the inter-bank term money market. This move is expected to set market-based benchmarks for pricing of loans and deposits, and hence improve transmission of monetary policy.<br>The introduction of LAF is an important landmark since it triggered a rapid transformation in the monetary policy operating environment in India. As a key element in the operating framework of the RBI, its objective is to assist banks to adjust their | |

day-to-day mismatches in liquidity. Currently, the RBI provides financial accommodation to the commercial banks through repos/reverse repos under the Liquidity Adjustment Facility (LAF).

| 30. | Q.11b(ii) | PYQ Nov 22 |
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**Briefly explain the concept of "Liquidity Trap".**

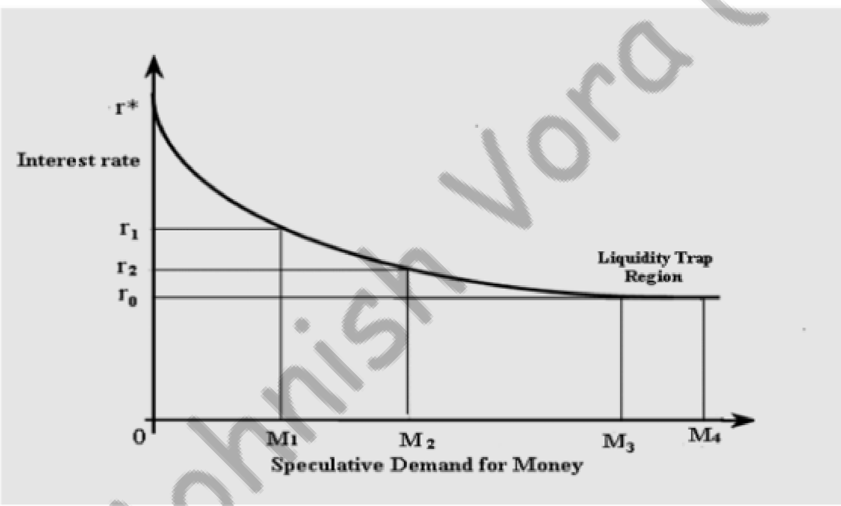
**OR**

**Why empirical analysis of money supply is important?**

**Ans.**

**Liquidity trap**

At a very high interest rate, say r*, the opportunity cost of holding money (in terms of foregone interest) is high and therefore, people will hold no money in speculative balances. When interest rates fall to very low levels, the expectation is that since the interest rate is very low it cannot go further lower and that in all possibility it will move upwards. In other words, investors would maintain cash savings rather than hold bonds. The speculative demand becomes perfectly elastic with respect to interest rate and the speculative money demand curve becomes parallel to the X axis. This situation is called a 'Liquidity trap'.




Aggregate Speculative Demand for Money

OR

**The empirical analysis of money supply is important for two reasons:**

(1) **It facilitates analysis of monetary developments** in order to provide a deeper understanding of the causes of money growth.

(2) It is essential from a monetary policy perspective as it provides a framework to evaluate whether the stock of money in the economy is consistent with the standards for price stability and to understand the nature of deviations from the standards. The central banks all over the world adopt monetary policy to **stabilize price level** and **GDP growth** by directly controlling the supply of money. This is achieved mainly by managing the quantity of monetary base. **The success of monetary policy depends to a large extent** on the controllability of the monetary base and the money supply

# CHAPTER 4 - International Trade

| 1. | Q.4b | MTP Mar 23 |
|---|---|---|
| | What is the distinction between Hard Peg and Soft Peg ? | |
| Ans. | Hard peg: An exchange rate policy where the central bank sets a fixed and unchanging value for the exchange rate.<br>Soft peg: An exchange rate policy under which the exchange rate is generally determined by the market, but in case the exchange rate tend to be move speedily in one direction, the central bank will intervene in the market. | |

| 2. | Q.4c | MTP Mar 23 |
|---|---|---|
| | What is the Anti-Dumping Duties? | |
| Ans. | An anti-dumping duty is a protectionist tariff that a domestic government imposes on imports that it believes are priced below fair market value. Dumping occurs when manufacturers sell goods in a foreign country below the sales prices in their domestic market or below their full average cost of the product. Dumping may be persistent, seasonal, or cyclical. Dumping may also be resorted to as a predatory pricing practice to drive out established domestic producers from the market and to establish monopoly position. | |

| 3. | Q.4d | MTP Mar 23 |
|---|---|---|
| | What is Rules of Origin as Instrument of trade Policy? | |
| Ans. | Country of origin means the country in which a good was produced, or in the case of a traded service, the home country of the service provider. Rules of origin are the criteria needed by governments of importing countries to determine the national source of a product. Their importance is derived from the fact that duties and restrictions in several cases depend upon the source of imports. Important procedural obstacles occur in the home countries for making available certifications regarding origin of goods, especially when different components of the product originate in different countries. | |

| 4. | Q.5a | MTP Mar 23 |
|---|---|---|
| | What are the advantage of floating Exchange Rate? | |
| Ans. | A floating exchange rate has many advantages:<br>(i) A floating exchange rate has the greatest advantage of allowing a Central bank and /or government to pursue its own independent monetary policy.<br>(ii) Floating exchange rate regime allows exchange rate to be used as a policy tool: for example, policymakers can adjust the nominal exchange rate to influence the competitiveness of the tradable goods sector.<br>(iii) As there is no obligation or necessity to intervene in the currency markets, the central bank is not required to maintain huge foreign exchange reserves. | |

| 5. | Q.3c | MTP April 23 |
|---|---|---|
| | What do you understand by depreciation of a currency? | |
| Ans. | Depreciation is a decrease in a currency's value (relative to other major currency benchmarks) due to market forces of demand and supply under a floating exchange rate and not due to any government or central bank policy actions. When a country's currency depreciates, foreigners find that its exports are cheaper and domestic residents find that imports from abroad are more expensive. | |

| 6. | Q.4a | MTP April 23 |
|---|---|---|
| | What are the non-technical measure of an instrument of trade Policy? | |
| Ans. | Non-technical Measures include different types of trade protective measures which are put into operation to neutralize the possible adverse effects of imports in the market of<br>• Import Quotas:<br>• Price Control Measures<br>• Non-automatic Licensing and Prohibitions<br>• Financial Measures<br>• Measures Affecting Competition<br>• Government Procurement Policies<br>• Trade-Related Investment Measures<br>• Distribution Restrictions:<br>• Restriction on Post-sales Services<br>• Administrative Procedures<br>• Rules of origin<br>• Safeguard Measures<br>• Embargos | |

| 7. | Q.4d | MTP April 23 |
|---|---|---|
| | What is the distinction between Anti-Dumping Duties and Countervailing Duties? | |
| Ans. | Dumping is unfair and constitutes a threat to domestic producers and therefore when dumping is found, anti-dumping measures may be initiated as a safeguard instrument by imposing additional import duties/tariffs so as to offset the foreign firm's unfair price advantage. This is justified only if the domestic industry is seriously injured by import competition, and protection is in the national interest.<br>Countervailing duties are tariffs that aim to offset the artificially low prices charged by exporters who enjoy export subsidies and tax concessions offered by the governments in their home country. If a foreign country does not have a comparative advantage in a particular good and a government subsidy allows the foreign firm to be an exporter of the product, then the subsidy generates a distortion from the free-trade allocation of resources. | |

| 8. | Q.5a | MTP April 23 |
|---|---|---|
| | What is Consumer Price Index (CPI) | |
| Ans. | It measures changes in the price level of market basket of consumer goods and services purchased by households; constructed using the prices of a sample of representative items whose prices are collected periodically. | |

| 9. | Q.5c | MTP April 23 |
|---|---|---|
| | **What is the essence of "MFN Principle"?** | |
| **Ans.** | MFN tariffs refer to import tariffs which countries promise to impose on imports from other members of the WTO, unless the country is part of a preferential trade agreement (such as a free trade area or customs union). This means that, in practice, MFN rates are the highest (most restrictive) that WTO members charge each other. Some countries impose higher tariffs on countries that are not part of the WTO. | |

| 10. | Q.3b | MTP Sept 22 |
|---|---|---|
| | **What is escalated tariff structure?** | |
| **Ans.** | Escalated Tariff structure 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., the tariff on a product increase as that product moves through the value-added chain. For example, a four percent tariff on iron ore or iron ingots and twelve percent tariff on steel pipes. This type of tariff is discriminatory as it protects manufacturing industries in importing © The Institute of Chartered Accountants of India 10 countries and dampens the attempts of developing manufacturing industries of exporting countries. This has special relevance to trade between developed countries and developing countries. Developing countries are thus forced to continue to be suppliers of raw materials without much value addition. | |

| 11. | Q.4b | MTP Sept 22 |
|---|---|---|
| | **What is meant by Foreign Portfolio Investment?** | |
| **Ans.** | Foreign portfolio investment (FPI) is not concerned with either manufacture of goods or with provision of services. Such investors also do not have any intention of exercising voting power or controlling or managing the affairs of the company in whose securities they invest. The sole intention of a foreign portfolio investor is to earn a remunerative return through investment in foreign securities and is primarily concerned about the safety of their capital, the likelihood of appreciation in its value, and the return generated. Logically, portfolio capital moves to a recipient country which has revealed its potential for higher returns and profitability. | |

| 12. | Q.5d | MTP Sept 22 |
|---|---|---|
| | **What is trading Block?** | |
| **Ans.** | Trading Bloc 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). | |

| 13. | Q.5a | MTP Oct 22 |
|---|---|---|
| | **Explain in brief The factor price equalization theorem?** | |
| **Ans.** | The factor price equalization theorem postulates that if the prices of the output of goods are equalized between countries engaged in free trade, then the price of the input factors will also be equalized between countries. This implies that the wages and rents will converge across the countries with free trade, or in other words, trade in goods is a perfect substitute | |

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| | for trade in factors. The Heckscher- Ohlin theorem, thus, puts forth that foreign trade eliminates the factor price differentials. The factor price equalization theorem is in fact a corollary to the Heckscher-Ohlin trade theory. It holds true only as long as Heckcher-Ohlin Theorem holds true. |

| 14. | Q.5b | MTP Oct 22 |
|---|---|---|
| | **What is meant by an 'Anti-dumping' measure?** | |
| **Ans.** | Dumping is unfair and constitutes a threat to domestic producers and therefore when dumping is found, anti-dumping measures may be initiated as a safeguard instrument by imposing additional import duties/tariffs so as to offset the foreign firm's unfair price advantage. This is justified only if the domestic industry is seriously injured by import competition, and protection is in the national interest (that is, the associated costs to consumers would be less than the benefits that would accrue to producers). For example: In January 2017, India imposed anti-dumping duties on colourcoated or pre- painted flat steel products imported into the country from China and European nations for a period not exceeding six months and for jute and jute products from Bangladesh and Nepal. | |

| 15. | Q.5c | MTP Oct 22 |
|---|---|---|
| | **What are the advantage of fixed exchange rate regime?** | |
| **Ans.** | A fixed exchange rate, also referred to as pegged exchange rate, is an exchange rate regime under which a country's government announces, or decrees, what its currency will be worth in terms of either another country's currency or a basket of currencies or another measure of value, such as gold.<br>A fixed exchange rate avoids currency fluctuations and eliminates exchange rate risks and transaction costs, enhances international trade and investment, and lowers the levels of inflation. But the central bank has to maintain an adequate amount of reserves and be always ready to intervene in the foreign exchange market. | |

| 16. | Q.5d | MTP Oct 22 |
|---|---|---|
| | **Distinguish between horizontal, vertical, type of foreign Investments.**<br>**OR**<br>**What is Import subsidies?** | |
| **Ans.** | **A horizontal direct investment** is said to take place when the investor establishes the same type of business operation in a foreign country as it operates in its home country, for example, a cell phone service provider based in the United States moving to India to provide the same service.<br>**A vertical investment** is one under which the investor establishes or acquires a business activity in a foreign country which is different from the investor's main business activity yet in some way supplements its major activity. For example, an automobile manufacturing company may acquire an interest in a foreign company that supplies parts or raw materials required for the company.<br>Or,<br>Import subsidies also exist in some countries. An import subsidy is simply a payment per unit or as a percent of value for the importation of a good (i.e., a negative import tariff) | |

| 17. | Q.3c | RTP May 23 |
|---|---|---|
| | **What are the Important Feature of Heckscher Ohlin Theory of International Trade?** | |
| **Ans.** | The Heckscher-Ohlin theory of trade states that comparative advantage in cost of production is explained exclusively by the differences in factor endowments of the nations. In a general sense of the term, 'factor endowment' refers to the overall availability of usable resources including both natural and man-made means of production. Nevertheless, in the exposition of the modern theory, only the two most important factors—labour and capital—are taken into account.<br><br>The Heckscher-Ohlin Trade Theorem establishes that a country tends to specialize in the export of a commodity whose production requires intensive use of its abundant resources and imports a commodity whose production requires intensive use of its scarce resources. | |

| 18. | Q.4a | RTP May 23 |
|---|---|---|
| | **Do you think if the developing Countries engage in liberal trade will be at disadvantage?** | |
| **Ans.** | International trade is often not equally beneficial to all nations. Potential unequal market access and disregard for the principles of fair-trading system may even amplify the differences between trading countries, especially if they differ in their wealth. Economic exploitation is a likely outcome when underprivileged countries become vulnerable to the growing political power of corporations operating globally. The domestic entities can be easily outperformed by financially stronger transnational companies.<br><br>Risky dependence of underdeveloped countries on foreign nations impairs economic autonomy and endangers their political sovereignty. Such reliance often leads to widespread exploitation and loss of cultural identity. Substantial dependence may also have severe adverse consequences in times of wars and other political disturbances. | |

| 19. | Q.5a | RTP May 23 |
|---|---|---|
| | **What are the effect of Tariff on an Imported Product?** | |
| **Ans.** | Tariffs encourage consumption and production of the domestically produced import substitutes and thus protect domestic industries. By making imported goods more expensive, tariffs discourage domestic consumers from consuming imported foreign goods. Domestic consumers suffer a loss in consumer surplus because they must now pay a higher price for the good and also because compared to free trade quantity, they now consume lesser quantity of the good.<br>Tariffs encourage consumption and production of the domestically produced import substitutes and thus protect domestic industries | |

| 20. | Q.5d | RTP May 23 |
|---|---|---|
| | **Elaborate on the Export Related Measure in International Trade?** | |
| **Ans.** | The Export Related measure in international trade is as under :<br>**Ban on exports:** Export-related measures refer to all measures applied by the government of the exporting country including both technical and non- technical measures. For example, during periods of shortages, export of agricultural products such as onion, wheat etc. may be prohibited to make them available for domestic consumption. | |

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| | **Export Taxes:** The effect of an export tax is to raise the price of the good and to decrease exports. Since an export tax reduces exports and increases domestic supply, it also reduces domestic prices and leads to higher domestic consumption.<br><br>**Export Subsidies and Incentives:** Tariffs on imports hurt exports and therefore countries have developed compensatory measures of different types for exporters like export subsidies, duty drawback, duty-free access to imported intermediates etc.<br><br>**Voluntary Export Restraints:** Voluntary Export Restraints (VERs) refer to a type of informal quota administered by an exporting country voluntarily restraining the quantity of goods that can be exported out of that country during a specified period of time. |

| 21. | Q.3a | RTP Nov 22 |
|---|---|---|
| | **What do you understand by Arbitrage?** | |
| **Ans.** | Arbitrage refers to the practice of making risk-less profits by intelligently exploiting price differences of an asset at different dealing locations. There is potential for arbitrage in the forex market if exchange rates are not consistent between currencies. When price differences occur in different markets, participants purchase foreign exchange in a low-priced market for resale in a high-priced market and makes profit in this process. Due to the operation of price mechanism, the price is driven up in the low-priced market and pushed down in the high-priced market. This activity will continue until the prices in the two markets are equalized, or until they differ only by the amount of transaction costs involved in the operation. Since forex markets are efficient, any profit spread on a given currency is quickly arbitraged away. | |

| 22. | Q.4c | RTP Nov 22 |
|---|---|---|
| | **How does appreciation and depreciation of currency affect real economy?** | |
| **Ans.** | Currency appreciation raises the price of exports, decrease exports; increase imports, adversely affect the competitiveness of domestic industry, cause larger deficits, and worsens the trade balance.<br><br>A depreciation of domestic currency primarily increases the price of foreign goods relative to goods produced in the home country and diverts spending from foreign goods to domestic goods.<br><br>When a country's currency depreciates, production for exports and of import substitutes become more profitable. Therefore, factors of production will be induced to move into the tradable goods sectors and out of the non- tradable goods sectors. The reverse will be true when the currency appreciates. These types of resource movements involve economic wastes. | |

| 23. | Q.5b | RTP Nov 22 |
|---|---|---|
| | **Domestic Industries and Consumers are affected by Import Quota, Comment.** | |
| **Ans.** | With a quota, the government, of course, receives no revenue. The profits received by the holders of such import licenses are known as 'quota rents. While tariffs directly interfere | |

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| | with prices that can be charged for an imported good in the domestic market, import quota interferes with the market prices indirectly. Obviously, an import quota always raises the domestic price of the imported good. The license holders are able to buy imports and resell them at a higher price in the domestic market and they will be able to earn a 'rent' on their operations over and above the profit they would have made in a free market. |

| 24. | Q.5d | RTP Nov 22 |
|---|---|---|
| | **In the theory of International Trade what is meant by factor endowment?** | |
| **Ans.** | In a general sense of the term, 'factor endowment' refers to the overall availability of usable resources including both natural and man-made means of production. Nevertheless, in the exposition of the modern theory, only the two most important factors—labour and capital—are taken into account. The Heckscher-Ohlin theory of trade states that comparative advantage in cost of production is explained exclusively by the differences in factor endowments of the nations. | |

| 25. | Q.7b | PYQ May 22 |
|---|---|---|
| | **State the features of Foreign Portfolio Investment** | |
| **Ans.** | Features of Foreign Portfolio Investment:<br>• Investment is only in financial assets<br>• Only short-term interest and generally remain invested for short periods<br>• Relatively easy to withdraw<br>• Not accompanied by technology transfer<br>• No direct impact on employment of labour and wages<br>• No abiding interest in management and control<br>• Securities are held purely as a financial investment and no significant degree of influence on the management of the enterprise<br>• Speculative in nature. | |

| 26. | Q.8a(ii) | PYQ May 22 |
|---|---|---|
| | **Write a brief note on Countervailing Duties.** | |
| **Ans.** | **Countervailing duties** are tariffs that aim to offset the artificially low prices charged by exporters who enjoy export subsidies and tax concessions offered by the governments in their home country. If a foreign country does not have a comparative advantage in a particular good and a government subsidy allows the foreign firm to be an exporter of the product, then the subsidy generates a distortion from the free-trade allocation of resources. In such cases, CVD is charged in an importing country to negate the advantage that exporters get from subsidies to ensure fair and market-oriented pricing of imported products and thereby protecting domestic industries and firms. | |

| 27. | Q.9b(ii) | PYQ May 22 |
|---|---|---|
| | **What do you mean by 'Bound Tariff'? Explain.** | |
| **Ans.** | The **bound tariff** rate is specific to individual products and represents the maximum level of import duty that can be levied on a product imported by that member. Under this, a WTO member binds itself with a legal commitment not to raise tariff rate above a certain | |

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| | level. By binding a tariff rate, often during negotiations, the members agree to limit their right to set tariff levels beyond a certain level. A member is always free to impose a tariff that is lower than the bound level. Once bound, a tariff rate becomes permanent, and a member can only increase its level after negotiating with its trading partners and compensating them for possible losses of trade. A bound tariff ensures transparency and predictability. |

| 28. | Q.10b(ii) | PYQ May 22 |
|---|---|---|
| | **Explain 'Sanitary and Phytosanitary (SPS) Measures'.** | |
| Ans. | **Sanitary and Phytosanitary (SPS) Measures**<br>SPS measures are applied to protect human, animal or plant life from risks arising from additives, pests, contaminants, toxins or disease-causing organisms and to protect biodiversity.<br>These include ban or prohibition of import of certain goods, all measures governing quality and hygienic requirements, production processes, and associated compliance assessments. For example, prohibition of import of poultry from countries affected by avian flu, meat and poultry processing standards to reduce pathogens, residue limits for pesticides in foods etc. | |

| 29. | Q.11b(ii) | PYQ May 22 |
|---|---|---|
| | **Explain briefly two key concepts of 'New Trade Theory' that gives advantages to countries that import goods to compete with the home country.**<br>**OR**<br>**Explain 'Embargos'.** | |
| Ans. | **New Trade Theory (NTT):** According to NTT, two key concepts that gives advantages to countries that import goods to compete with products from the home country are:<br>**Economies of Scale:** As a firm produces more of a product, its cost per unit keeps going down. So, if the firm serves domestic as well as foreign market instead of just one, then it can reap the benefit of large scale of production consequently the profits are likely to be higher.<br>**Network effects:** It refer to the way one person's value for 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'. Consumers like more choices, but they also want products and services with high utility, and the network effect increases utility obtained from these products over others. A good example will be Mobile App such as What's App and software like Microsoft Windows.<br>Or<br>**Embargos:**<br>An embargo is a total ban imposed by government on import or export of some or all commodities to particular country or regions for a specified or indefinite period. This may be done due to political reasons or for other reasons such as health, religious sentiments. This is the most extreme form of trade barrier. | |

| 30. | Q.7b | PYQ Nov 22 |
|---|---|---|
| | **What are the two forms, through which foreign capital may flow into an economy, as an investment?** | |
| Ans. | **Forms of foreign capital into an economy**<br>The two forms through which foreign capital may flow into an economy as investments are:<br><br>**Foreign portfolio investment (**FPI) in bonds, stocks and securities, and **Foreign direct investment** (FDI) in industrial, commercial, and similar other enterprises.<br><br>Foreign direct investment is defined as a process whereby the resident of one country (i.e., home country) acquires ownership of an asset in another country (i.e., the host country) and such movement of capital involves ownership, control as well as management of the asset in the host country.<br><br>Foreign portfolio investment is the flow of 'financial capital' with stake in a firm at below 10 percent and does not involve manufacture of goods or provision of services, ownership management or control of the asset on the part of the investor. | |

| 31. | Q.8a(i) | PYQ Nov 22 |
|---|---|---|
| | **The Rupee dollar exchange rate for two different periods of a particular financial year are as follows:**<br>**(1) In the month of January it is \$ 1 = ₹ 65; and**<br>**(2) In the month of April it is \$ 1 = ₹ 70**<br>**Answer:**<br>**A. What does this indicate?**<br>**B. Who will be benefited, either residents of India or foreigners?**<br>**C. Explain the impact of exchange fluctuations in terms of appreciation of currency on inflation** | |
| Ans. | A. It indicates the **depreciation of Rupee and appreciation of Dollar**<br><br>B. Exports become cheaper and more attractive to foreigners; imports will be discouraged as they become costlier to import.<br><br>C. **Impact on inflation:**<br>An appreciation may **cause reduction in the levels of inflation** because imports are cheaper. Lower price of imported capital goods, components and raw materials lead to a **decrease in cost of production** which reflects on decrease in prices. Additionally, decrease in aggregate demand tends to **lower demand pull inflation**. **Living standards of people are likely to improve** due to availability of cheaper consumer goods. | |

| 32. | Q.9b(i) | PYQ Nov 22 |
|---|---|---|
| | **Tariffs are basically taxes or duties on goods and services which are imported or exported. Briefly explain Preferential, Applied and Escalated tariff.** | |
| Ans. | Tariffs are basically taxes or duties imposed on goods and services which are imported or exported. It is defined as a financial charge in the form of a tax, imposed at the border on | |

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| | goods going from one customs territory to another. Different tariffs are generally applied to different commodities.<br>**Preferential Tariff:** Nearly all countries are part of at least one preferential trade agreement, under which they promise to give another country's products lower tariffs than their MFN rate. These agreements are reciprocal.<br>**Applied Tariff:** An 'applied tariff' is the duty that is actually charged on imports on a Most-Favoured Nation (MFN) basis. A WTO member can have an applied tariff for a product that differs from the bound tariff for that product as long as the applied level is not higher than the bound level.<br>**Escalated Tariff:** Escalated Tariff structure 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. the tariff on a product increases as that product moves through the value-added chain. |

| 33. | Q.10a(i) | PYQ Nov 22 |
|---|---|---|
| | **Discuss with example the following types of Foreign Direct Investment.**<br>**(A) Horizontal Direct Foreign Investment**<br>**(B) Vertical Direct Foreign Investment**<br>**(C) Two-way Direct Foreign Investment.** | |
| **Ans.** | **(A) Horizontal Direct Foreign Investment:** A horizontal direct investment is said to take place when the investor establishes the same type of business operation in a foreign country as it operates in its home country, for example, a cell phone service provider based in the United States moving to India to provide the same service.<br><br>**(B) Vertical Direct Foreign Investment:** A Vertical Investment is one under which the investor establishes or acquires a business activity in a foreign country which is different from the investor's main business activity yet in some way supplements its major activity. For example, an automobile manufacturing company may acquire an interest in a foreign company that supplies parts or raw materials required for the company.<br><br>**(C) Two – way Direct Foreign Investment:** Two- Way Direct Foreign Investments' which are reciprocal investments between countries. These investments occur when some industries are more advanced in one nation (for example, the computer industry in the United States), while other industries are more efficient in other nations (such as the automobile industry in Japan). | |

| 34. | Q.11a(ii) | PYQ Nov 22 |
|---|---|---|
| | **What are the guiding principles of World Trade Organization (WTO).** | |
| **Ans.** | Right from its inception, the WTO has been driven by a number of fundamental principles which are the foundations of the multilateral trading system. Following are the major **guiding principles**:<br>▪ Trade without discrimination<br>▪ The National Treatment Principle (NTP)<br>▪ Freer trade<br>▪ Predictability | |

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| | ▪ Principle of general prohibition of quantitative restrictions<br>▪ Greater competitiveness<br>▪ Tariffs as legitimate measures for the protection of domestic industries<br>▪ Transparency in Decision Making<br>▪ Progressive Liberalization:<br>▪ Market Access<br>▪ Special privileges to less developed countries<br>▪ Protection of Health & Environment<br>▪ A transparent, effective, and verifiable dispute settlement mechanism. |