SSEI
Sanjay Saraf Educational Institute Pvt. Ltd.
A positive NPV Training Center

CA INTER

ECONOMICS FOR FINANCE

SUPER 50

- Sanjay Saraf Sir

SSEI TELEGRAM CHANNEL

SSEI QFORUM

SSEI DIRECT

SSEI CA INTER ACADEMIC DISCUSSION

TELEGRAM CHANNEL FOR CA

TELEGRAM CHANNEL FOR CFA

TELEGRAM CHANNEL FOR FRM & STOCK MARKET

Question 1.

Is country like India unable to estimate their National Income wholly by one method? Give comments

Answer :

Yes, Countries like India are unable to estimate their national income wholly by one method. There are various sectors in an economy and national income generated by these sectors is estimated by using different methods. For example, in agricultural sector, net value added is estimated by the production method, in small scale sector net value added is estimated by the income method and in the construction sector net value added is estimated by the expenditure method.

Question 2.

The equilibrium level of income of an economy is Rs.2,000crores. The autonomous consumption expenditure is equal to Rs.100 crores and investment expenditure is Rs.500 crores.

Calculate.

i. Consumption expenditure level of National Income.

ii. Marginal propensity to save and Marginal propensity to consume

iii. Break-even level of Income.

Answer :

i. Consumption expenditure at equilibrium level of National Income

Y = C + I [AD = C + I]

Putting the value of Investment Expenditure (I) = Rs.500 Crores and Income (Y) = Rs. 2000 crores, we get

C = 2,000 – 500

C= Rs.1500 Crores

ii. Marginal Propensity to Save (MPS)Consumption function is given by

C = a + bY

1500 = 100 + 2000 b

2000 b = 1400 MPC = 0.7

MPS = 1-MPC = 1-0.7 = 0.3

iii. Break-even level of Income attained at break-even point = C = Y

Putting Y = C

Y = 100 + 0.7 Y

0.3Y = 100

Y = 333.33

Question 3.

Define aggregate demand. How do you derive the Keynesian aggregate demand schedule?

Answer :

Aggregate demand is the total quantity of finished goods and services that all sectors (consumers, firms, government and the rest of the world) together wish to buy under different conditions. The components of aggregate demand are consumption demand, investment demand, government spending and net exports at each level of income. While consumption demand is a function of the level of disposable income, the demand for investment, government spending and net exports are autonomous, i.e. these are determined outside the model and are specifically assumed to be independent of income.

The Keynesian aggregate demand schedule is obtained by vertically adding the demand for consumption, investment demand, government spending and net exports at each level of income.

Question 4.

Distinguish between Personal Income and Disposable Income.

Answer :

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 of time. It is the income 'actually paid out' to the household sector, but not necessarily earned. Some people obtain income for which no goods and services are provided in return. Examples of this include transfer payments such as social security benefits, unemployment compensation, welfare payments etc. Individuals also earn income which they do not actually receive; for example, undistributed corporate profits and the contribution of employers to social security. Personal income forms the basis for consumption expenditures and is derived from national income as follows:

PI = NI + income received but not earned - income earned but not received.

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.

DI = PI - Personal Income Taxes

Question 5.

Distinguish between Nominal and Real GDP.

Answer :

GDP is essentially a quantity measure and therefore when value of output is measured in terms of market prices, it is sensitive to changes in the average price level. The same physical output will correspond to a different GDP level if the average level of market prices changes. That is, if prices rise, GDP measured at market prices will also rise without any real increase in physical output.

This is misleading because it does not reflect the changes in the actual volume of output. To correct this i.e. to eliminate the effect of prices, in addition to computing GDP in terms of current market prices, termed 'nominal GDP' or 'GDP at current prices', the national income accountants also calculate 'real GDP 'or 'GDP at constant prices' which is the value of domestic product in terms of constant prices of a chosen base year. Real GDP changes only when production changes. As a rule, when prices are changing drastically, nominal GDP and real GDP diverge substantially. The converse is true when prices are more or less constant.

Question 6.

How are the following transactions treated in national income calculation? What is the rationale in each case?

i. Electricity sold to a steel plant.

ii. Electric power sold to a consumer household.

iii. A car manufacturer procuring parts and components from the market.

iv. A computer producer buys a robot produced in the same country and uses it in production of computers.

v. A set of four tyres produced by MRF in 2017 and sold to Suzuki to be put on a 2017 car.

Answer :

i. Being an intermediate good, electricity sold to a steel plant will not be included in national income calculation. The underlying principle is that only finished goods and services which are directly sold to the consumer for final consumption would be included.

ii. Electric power sold to a consumer household would be included in the calculation of GDP since it is a final good consumed by the end user.

iii. The value of parts and components procured from the market by a car manufacturer will not be included in national income calculation because these are intermediate goods used in car production.

iv. The value of the robot bought by a computer producer for use in the production of computers would be included in national income calculation because the computer producer is the "final consumer" of the robot and the robot is not resold in the market after value addition.

v. The value of parts and components procured from the market by a car manufacturer will not be included in national income calculation because these are intermediate goods used in car production. Value is added to the parts and components through the process of production and the same is resold. The value of the final output, namely car, includes the value of the parts and components. Counting parts and components separately will lead to the error of double

counting and exaggerate the value of car production. A set of four tyres produced by MRF in 2017 and sold to Suzuki to be put on a 2017 car will not be included in the national income of 2017.

Question 7.

The equilibrium level of real GDP is Rs 1,000 billion, the full employment level of real GDP is Rs 1,250 billion, and the marginal propensity to consume (MPC) is 0.60. How much government spending ("G) would be needed to raise income to full-employment level?

Answer :

K= 1/1-MPC

= 1/1-0.6

= 2.5

$$K = \frac{\Delta Y}{\Delta G}$$

$$2.5 = \frac{1250 - 1000}{\Delta G}$$

$$\Delta G = 100 \text{ billion}$$

Question 8.

An Economy is characterised by the following equations:

Consumption (C)	**=**	**100+0.9 Yd**
Investment (I)	**=**	**100**
Government Expenditure (G)	**=**	**120**
Tax (T)	**=**	**50**
X (Exports)	**=**	**200**
M (Imports)	**=**	**100+ 0.15 Y**

i. What is the equilibrium Income?

ii. Calculate trade balance.

iii. What is the value of Foreign Trade Multiplier?

Answer :

i. National Income:

Y = C+I+G+(X-M)

= (100+0.9Yd) +100+120+200-(100+0.15Y)

= 100+0.9(Y-T) +100+120+200-100-0.15Y

= 100+0.9(Y-50) +100+120+200-100-0.15Y

Y = 375+0.75Y

Y-0.75Y = 375

0.25Y = 375

Y = 375 ×100/25= 1500.00

ii. Trade balance = X- M

= 200- (100+0.15Y)

Substituting the value of Y We have

Trade Balance = 200-100-225= -125

Trade balance is in deficit of 125.

iii. Value of foreign trade Multiplier = 1/1-b+m

Where b marginal propensity to consume, and m is marginal propensity to import.

(Here MPC = 0.9 and marginal propensity to Import (m) = 0.15

Foreign trade Multiplier = 1/1-0.9+0.15 = 4

Question 9.

Explain the leakages and injections in the circular flow of income.

Answer :

Leakages: A leakage is an outflow or withdrawal of income from the circular flow. Leakages are money leaving the circular flow and therefore, not available for spending on currently produced goods and services. Leakages reduce the flow of income.

Injections: An injection is a non-consumption expenditure. It is an expenditure on goods and services produced within the domestic territory but not used by the domestic household for consumption purposes. Injections are exogenous additions to the circular flow and add to the total volume of the basic circular flow. In the two-sector model with households and firms, household saving is the only leakage and investment is the only injection. In the three -sector model which includes the government, saving and taxes are the two leakages and investment and government purchases are the two injections.

In the four-sector model which includes foreign sector also, saving, taxes, and imports are the three leakages; investment, government purchases, and exports are the three injections.

The state of equilibrium occurs when the total leakages are equal to the total injections that occur in the economy. Savings + Taxes + Imports = Investment + Government Spending + Exports

Question 10.

Calculate Personal Income from the following data:

Particulars	In Crore
Undistributed profits of corporation	50
Net domestic product accruing to private sector	700
Corporation tax	65
Net factor income from abroad	10
Net current transfer from rest of the world	20
Net current transfer from the government	25
Interest on national debt	40

Answer :

Personal Income = Net domestic product accruing to private sector + Net factor

income from abroad + Net current transfers from government + Net current transfers from rest of the world + interest on National debt – Corporation tax – Undistributed profits of corporations

= 700 + 10 + 25 + 20 + 40 - 65 - 50 = 680 Crores

Question 11.

Calculate Gross National Disposable income from the following data (in ₹ Crores)

NDP at factor cost	**6000**
Net factor income to abroad	**- 300**
Consumption of fixed capital	**400**
Current transfers from government	**200**
Net current transfers from rest of the world	**500**
Indirect taxes	**700**
Subsidies	**600**

Answer :

Gross National Disposable Income (GNDI)= GNPMP + Net current transfer received from rest of the world. Net current transfer received from rest of the world is the difference between the current transfer received from rest of the world and current transfers paid to rest of the world. Current transfers from government are not included as they are simply transfers within the economy.

Gross National Disposable Income = (National Consumption Expenditure) + (Gross National Saving)

= (Government final consumption expenditure+ expenditure) + (Gross National Saving.)

Calculation:

= NDP at factor cost + Consumption of fixed capital =GDP at factor cost

GDP at factor cost + Net factor income to abroad = GNP at factor cost

GNP at factor cost + (indirect taxes – subsidies) = GNP at market prices

GNP at market prices + Net current transfers from rest of the world

= Gross National Disposable income

= (6000+400) + (- 300) + (700-600) + 500

= 6400 - 300 + 100 + 500 = 6700 Crores

Question 12.

What would happen if aggregate expenditures were to exceed the country's economy's production capacity?

Answer :

Aggregate demand (AD) is the sum of all planned expenditures for the entire economy. When aggregate expenditures exceed an economy's production capacity at full employment level; the resulting strain on resources creates "demand-pull" inflation or higher price level. Nominal output will increase, but it merely reflects higher prices, rather than additional real output.

Question 13.

i. How the autonomous expenditure multiplier is stated in four sector model?

ii. If an economy has a flat aggregate expenditure function, what would be the nature of the multiplier?

Answer :

i. The autonomous expenditure multiplier in a four sector model includes the effects of foreign transactions and is stated as 1/1-b + v where v is the propensity to import which is greater than zero. The greater the value of v, the lower will be the autonomous expenditure multiplier.

ii. The marginal propensity to consume (MPC) is the determinant of the value of the multiplier and that there exists a direct relationship between MPC and the value of multiplier. Higher the MPC, more will be the value of the multiplier and vice-versa. A flat aggregate expenditure function implies lower MPC and higher MPS for all levels of income. Therefore, the value of multiplier will be small.

Question 14.

i. Calculate the Operating Surplus with the help of following data-

Particulars ₹	(In Crore)
Sales	4,000
Compensation to employees	800
Intermediate consumption	600
Rent	400
Interest	300
Net indirect taxes	500
Consumption of fixed capital	200
Mixed income	400

ii. Why do pensions and other security payments get excluded while calculating National Income?

Answer :

i. GVAMP = Gross Value OutputMP – Intermediate consumption

= (Sales + change in stock) – Intermediate consumption

= 4000-600 = 3400 crore

GDPMP = GVAMP = 3400 crore

NDPMP = GDPMP – consumption of fixed capital

= 3400 – 200 = 3200 crore

NDPFC = NDPMP – NIT

= 3200 – 500 = 2700 crore

NDPFC = Compensation of employees + Operating surplus + Mixed income

2700 = 800 + Operating Surplus + 400

Operating surplus = 1500 crore

ii. GDP measures what is produced or created over the current time period and excludes all non-production transactions. Only incomes earned by owners of primary factors of production for services rendered in production are included in

national income. Transfer payments, both private and government, are made without goods or services being received in return. These payments do not correspond to return for contribution to production because they do not directly absorb resources or create output. Therefore, transfer incomes such as pensions and other social security payments are excluded from national income.

Question 15.

The price index for exports of Bangladesh in the year 2018-19 (based on 2010-11) was 233.73 and the price index for imports of it was 220.50 (based on 2010-11) What do these figures mean ?

Answer :

The figures represent foreign trade price indices which are compiled using prices of specified group of commodities exported from and imported by Bangladesh in the year 2018-19. Both indices have a base year of 2010 -11 (=100) and the price changes are measured in relation to that figure. In the current year, the import price index of 220.50 indicates that there has been a 120.50 percent increase in price since 2010-11 and export price index shows that there is 133.73 percent increase in export prices. These indices track the changes in the price which firms and countries receive / pay for products they export/ import and can be used for assessing the impact of international trade on the domestic economy.

Question 16.

Define Social Good? What is the similarity and dissimilarity between Social Goods and Common Pool Resources?

Answer :

A Social Good is defined as one which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction from any other individuals consumption of that good. Similarity between Social Goods and Common Pool Resources is that both are nonexcludable whereas dissimilarity is seen in their nature that is Social Goods are non-rival which means that the use of these goods does not reduce the availability for others, while Common Pool Resources are rival in nature which means that the use of these resources reduce the availability for others.

Question 17.

What is the crux of Heckscher-Ohlin theory of International Trade

Answer :

The Heckscher-Ohlin theory of trade, also referred to as Factor-Endowment Theory of Trade or Modern Theory of Trade, states that comparative advantage in cost of production is explained exclusively by the differences in factor endowments.

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.

Accordingly, a capital abundant country will produce and export capital intensive goods relatively more cheaply and a labour-abundant country will produce and export labour intensive goods relatively more cheaply than another country.

Question 18.

You are the Finance Minister of India. You find that the country is passing through recession. As Finance Minister what suggestions will you make to the Government of India to bring the country out of recession.

Justify your answer.

Answer :

A recession is said to occur when overall economic activity declines or in other words, when the economy contracts. As a Finance Minister it is my responsibility to frame / suggest fiscal policy for the country at the time of recession or inflation so as to take the country out of it.

Fiscal policy involves the use of government spending, taxation and borrowing to influence both the pattern of economic activity and level of growth of aggregate demand, output and employment.

Fiscal measures could be discretionary and non-discretionary.

During recession, the government has to use discretionary fiscal policies. 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. Since GDP = C + I + G + NX, governments can influence economic activity (GDP), by controlling G (Government Expenditure) directly and influencing C(Private Consumption), I(Private Investment), and NX (Net Exports) indirectly, through changes in taxes, transfer payments and expenditure.

During a recession as a part of government I may initiate a fresh wave of public works. These will involve employment of labour as well as purchase of multitude of goods and services. These expenditures directly generate incomes to labour and suppliers of material and services. Apart from this, there is also indirect effect in the form of working of multiplier.

Besides this, as a finance minister, I may reduce corporate and personal income tax to overcome contractionarily tendencies in the economy. A tax cut increases disposable income of households.

Their inclination to spend a portion of additional disposable income determined by their marginal propensity to consumer and multiplier effect of spending would set out a chain reaction of spending, increased income and consequent increases output. Moreover, these can provide firms and households incentives to engage in investment.

Question 19.

Suppose a fertilizer plant dumps effluents into a river, why is it called an externality?

Answer :

When a fertilizer plant dumps effluents into a river, there is negative externality because it adversely affects the quality of water and reduces the welfare of the people who use it. The users of polluted water are third parties and are not in any way connected with the economic transactions that take place within the fertilizer factory. The fertilizer producer does not bear the true cost of wastewater to the society and the fertilizer prices do not include the costs borne by these third parties. Therefore, the fertilizer producer will have an incentive to produce too much effluents. The price of fertilizer which is equal to the marginal cost of production will be lower than what it would be if the cost of production reflected the effluent cost also.

Question 20.

Why is it difficult for the government to determine the optimal quantity of a public good?

Answer :

It is difficult for the government to determine the optimal quantity of a public good because consumer preferences for these goods are not revealed in the market and a price cannot be charged since they are non rival and non-excludable in consumption and are characterized by indivisibility.

Question 21.

Distinguish between 'pump priming' and 'compensatory spending'

Answer :

A distinction is made between the two concepts of public spending during depression, namely, the concept of 'pump priming' and the concept of 'compensatory spending'. 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 setoff 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.

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.

Question 22.

What should be the public revenue and expenditure policy during recession?

Answer :

Government's fiscal policy for stabilization purposes attempts to direct the actions of individuals and organizations by means of its expenditure and taxation decisions.

During recession, an expansionary fiscal policy is resorted to by government through increased aggregate spending to compensate for the deficiency in effective demand.

Increased government expenditure (for example on building infrastructure) injects more money into the economy, initiate a series of productive activities, stimulates overall economic activities, employment and demand.

Production decisions, investments, savings etc can be influenced by government's tax policies. During recession, the government's tax policy is framed to encourage private consumption and investment. A general reduction in income taxes leaves higher disposable incomes with people inducing higher consumption. Low corporate taxes increase the prospects of profits for business and promote further investment.

Question 23.

What do you mean by 'Global Public goods'. Explain in brief.

Answer :

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. Global Public Goods may be:

- final public goods which are 'outcomes' such as ozone layer preservation or climate change prevention, or
- intermediate public goods, which contribute to the provision of final public goods. e.g. International health regulations

The distinctive characteristic of global public goods is that there is no mechanism (either market or government) to ensure an efficient outcome.

The World Bank identifies five areas of global public goods which it seeks to address: namely, the environmental commons (including the prevention of climate change and biodiversity), communicable diseases (including HIV/AIDS, tuberculosis, malaria, and avian influenza), international trade, international financial architecture, and global knowledge for development.

Question 24.

i. Outline different components of monetary policy framework for India?

ii. Write a note on two major components of Reserve Money

Answer :

i. The central bank in its execution of monetary policy, functions within an articulated monetary policy framework which comprises of:

- the objectives of monetary policy, such as maintenance of price stability (or controlling inflation) and achievement of economic growth
- the analytics of monetary policy which focus on the transmission mechanisms, or the ways in which monetary policy actions get transmitted to the real economy and
- the operating procedure which relates to all aspects of implementation of monetary policy namely, choosing the operating target, choosing the intermediate target, and choosing the policy instruments.

ii. Reserve money has two major components – currency in circulation and reserves. Currency in circulation comprises currency with the public and cash in hand with banks. Reserves are bank deposits with the central bank.

Question 25.

What would be the effect of automatic stabilizers on multiplier?

Answer :

An automatic stabilizer is any feature of an economy that automatically reduces the changes in spending during the multiplier process, making the multiplier smaller. As GDP increases, an automatic stabilizer would reduce the increases in spending in each round of the multiplier making the final increase in GDP less than what would otherwise be. Therefore, automatic stabilizers reduce the size of the multiplier, and consequently reduce fluctuations in GDP and employment, making the economy more stable in the short run. Briefly put, automatic stabilizers diminish the impact of spending changes on real GDP.

Question 26.

Explain how higher of interest rate affect the demand for money.

Answer :

The demand for money is a decision about how much of one's given stock of wealth should be held in the form of money rather than as other assets such as bonds. Demand for money is actually demand for liquidity and a demand to store value.

Demand for money is in the nature of derived demand; it is demanded for it purchasing power.

Basically people demand money because they wish to have command over real goods and services with the use of money.

Demand for money has an important role in the determination of interest, prices and income in an economy. Higher the interest rate, higher would be opportunity cost of holding cash and lower the demand for money. Similarly, lower the interest rate, lower will be the opportunity cost of holding cash and higher the demand for money.

Question 27.

Define money supply. Describe the different components of money supply.

Answer :

The measures of money supply vary from country to country, from time to time and from purpose to purpose.

The high-powered money and the credit money broadly constitute the most common measure of money supply, or the total money stock of a country. High powered money is the source of all other forms of money. The second major source of money supply is the banking system of the country.

Money created by the commercial banks is called 'credit money'. Measurement of money supply is essential from a monetary policy perspective because it enables a framework to evaluate whether the stock of money in the economy is consistent with the standards for price stability, to understand the nature of deviations from this standard and to study the causes of money growth. The stock of money always refers to the total amount of money at any particular point of time i.e. it is the stock of money available to the 'public' as a means of payments and store of value and does not include inter-bank deposits.

The monetary aggregates are:

M1 = Currency and coins with the people + demand deposits of banks (Current and Saving accounts) + other deposits of the RBI;

M2 = M1 + savings deposits with post office savings banks,

M3 = M1 + net time deposits of banks and

M4 = M3 + total deposits with the Post Office Savings Organization (excluding National Savings Certificates)

Question 28.

Explain how Reserve Bank of India acts as a 'lender of last resort 'to commercial banks? Or Explain the operation of Marginal Standing Facility?

Answer :

The Marginal Standing Facility (MSF) is the last resort for banks to obtain funds once they exhaust all borrowing options including the liquidity adjustment facility on which the rates are lower compared to the MSF. Under this facility, the scheduled commercial banks can borrow additional amount of overnight money from the central bank over and above what is available to them through the LAF window by dipping into their Statutory Liquidity Ratio (SLR) portfolio up to a limit (a fixed per cent of their net demand and time liabilities deposits (NDTL) liable to change) at a penal rate of interest. The scheme has been introduced by RBI with the main aim of reducing volatility in the overnight lending rates in the inter-bank market and to enable smooth monetary transmission in the financial system. This provides a safety valve against unexpected liquidity shocks to the banking system.

Question 29.

Explain the Cambridge Version of Cash Balance Approach Md = k P Y

Answer :

In the early 1900s, Cambridge Economists Alfred Marshall, A.C. Pigou, D.H. Robertson and John Maynard Keynes (then associated with Cambridge) put forward a fundamentally different approach to quantity theory, known neoclassical theory or cash balance approach. The Cambridge version holds that money increases utility in the following two ways:

1. enabling the possibility of split-up of sale and purchase to two different points of time rather than being simultaneous, and
2. being a hedge against uncertainty.

While the first above represents transaction motive, just as Fisher envisaged, the second points to money's role as a temporary store of wealth. Since sale and purchase of commodities by individuals do not take place simultaneously, they need a 'temporary abode' of purchasing power as a hedge against uncertainty. As such, demand for money also involves a precautionary motive in Cambridge approach. Since money gives utility in its store of wealth and precautionary modes, one can say that money is demanded for itself.

Now, the question is how much money will be demanded? The answer is: it depends partly on income and partly on other factors of which important ones are wealth and interest rates. The former determinant of demand i.e. income, points to transactions demand such that higher the income, the greater the quantity of purchases and as a consequence greater will be the need for money as a temporary abode of value to overcome transactions costs. The Cambridge equation is stated as:

Md = k PY, Where Md = is the demand for money

Y = real national income

P = average price level of currently produced goods and services

PY = nominal income

k = proportion of nominal income (PY) that people want to hold as cash balances

The term 'k' in the above equation is called 'Cambridge k'. The equation above explains that the demand for money (M) equals k proportion of the total money income.

Thus we see that the neoclassical theory changed the focus of the quantity theory of money to money demand and hypothesized that demand for money is a function of money income.

Both these versions are chiefly concerned with money as a means of transactions or exchange, and therefore, they present models of the transaction demand for money.

Question 30.

Why empirical analysis of money supply is important?

Answer :

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 this standard. The central banks all over the world adopt monetary policy to stabilise 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 money supply and the monetary base.

Question 31.

What is high powered money? Calculate it from the following data:

Components in Million (₹)	
Net RBI Credit to the Government	41561.2
RBI credit to the Commercial sector	18459.3
RBI's net non-monetary liabilities	24981.2
RBI's claims on banks	31456.2
RBI's Net foreign assets	10456.1
Government's currency liabilities to the public	21417.1

Answer :

High powered money is also known as reserve money which determines the level of liquidity and price level in the economy.

Reserve Money = Net RBI Credit to the Government + RBI credit to the Commercial sector+ RBI's claims on banks+ RBI's Net foreign assets+ Government's currency liabilities to the public- RBI's net non- monetary liabilities

= 41561.2 + 18459.3 + 31456.2 + 10456.1 + 21417.1 - 24981.2 = 98368.7 million

Question 32.

Which of the functions of money do the following items satisfy?

i. A credit card.

ii. A token of specified amount of money which can be used for shopping

Answer :

i. A credit card is a medium of exchange

ii. A token of specified amount of money which can be used for shopping satisfies all 3 functions of money, which are store of value, unit of account, and medium of exchange.

Question 33.

Explain the function of SLR? What are the eligible securities of SLR?

Answer :

The Statutory Liquidity ratio (SLR) is an instrument of monetary policy and aims to control 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.

Following are the eligible securities of SLR;

i. Cash

ii. Gold valued at a price not exceeding the current market price,

or

iii. Investments in un-encumbered Instruments that include:

- **a.** Treasury-bills of the Government of India.
- **b.** Dated securities including those issued by the Government of India fromtime to time under the market borrowings programme and the Market Stabilization Scheme (MSS).
- **c.** State Development Loans (SDLs) issued by State Governments under their market borrowings programme.
- **d.** Other instruments as notified by the RBI.

Question 34.

Explain the effect of currency devaluation? Do you think a weak currency is advantageous to a country?

Answer :

Devaluation is a deliberate downward adjustment in the value of a country's currency relative to another currency, group of currencies or standard. It is a policy tool used by countries that have a fixed exchange rate or nearly fixed exchange rate regime and involves a discrete official reduction in the otherwise fixed par value of a currency. The monetary authority formally sets a new fixed rate with respect to a foreign reference currency or currency basket.

Devaluation is primarily an expenditure switching policy. Ceteris paribus, the weakening of currency can have positive effects on an economy's trade balance.

Devaluation increases the price of foreign goods relative to goods produced in the home country and diverts spending from foreign goods to domestic goods.

Devaluation implies that foreigners pay less for the devalued currency and that the residents of the devaluing country pay more for foreign currencies. By lowering export prices, devaluation helps increase the international competitiveness of domestic industries and increases the volume of exports.

Devaluation lowers the relative price of a country's exports, raises the relative price of its imports, increases demand both for domestic import-competing goods and for exports, leads to output expansion, encourages economic activity, increases the international competitiveness of domestic industries, increases the volume of exports and promotes trade balance.

Question 35

Explain the Monetary Policy Framework Agreement.

Answer :

The Reserve Bank of India (RBI) Act, 1934 was amended in 2016, for giving a statutory backing to the Monetary Policy Framework Agreement. It is an agreement reached between the Government of India and the RBI on the maximum tolerable inflation rate that the RBI should target to achieve price stability.

The amended RBI Act (2016) provides for a statutory basis for the implementation of the 'flexible inflation targeting framework' by abandoning the 'multiple indicator' approach. T he inflation target is to be set by the Government of India, in consultation with the Reserve Bank, once in every five years.

Accordingly,

- The Central Government has notified 4 per cent Consumer Price Index (CPI) inflation as the target for the period from August 5, 2016 to March 31, 2021 with the upper tolerance limit of 6 per cent and the lower tolerance limit of 2 per cent.
- The RBI is mandated to publish a Monetary Policy Report every six months, explaining the sources of inflation and the forecasts of inflation for the coming period of six to eighteen months.

Question 36.

Calculate liquidity aggregate L2 when the following information is given-

Particulars	₹ in crore
Term deposits with term lending institutions	750
Term borrowing by refinancing institutions	450
All deposits with post office savings banks	1320
Term deposits with refinancing institutions	590
Certificate of deposits issued by FIs	290
Public deposits of non-banking financial companies	450
NM3	2650
National saving certificates	240

Answer :

L2 = L1 + Term deposits with term lending institutions + Term deposits with refinancing institutions + Term borrowing by refinancing institutions + Certificate of deposits issued by FIs

Where L1 = NM3 + All deposits with post office savings banks
= 2650 + 1320
= 3970 crore

Therefore L2 = 3970 + 750 +590 + 450 + 290
= 6050 crore

Question 37.

Assume that 15% specific tariff is levied by the government on every sunglass which is imported into India, and if 2000 sunglasses are imported and price of each sunglass is Rs.1000/- , then find out the amount of total tariff revenue collected by the government?

Answer :

Specific tariff is an import duty which levied as a fixed charge per unit of the good imported. Therefore amount in total tariff revenue = 2000 × 15% = Rs. 300/- In this case, total Rs. 300/- is collected, whether the price of a sunglass is of Rs. 1000 or Rs. 2000 for different brand.

Question 38.

The table below shows the number of labour hours required to produce wheat and cloth in two countries X and Y.

Commodity	Country X	Country Y
1 unit of cloth	4	1.0
1 unit of wheat	2	2.5

i. Compare the productivity of labour in both countries in respect of both commodities

ii. Which country has absolute advantage in the production of wheat?

iii. Which country has absolute advantage in the production of cloth? What is meant by Crowding out?

Answer :

i. Productivity of labour (output per labour hour = the volume of output produced per unit of labour input)
= output / input of labour hours

Output of commodity	Units in Country X	Units in Country Y
Cloth	0.25	1.0
Wheat	0.50	0.4

ii. A country has an absolute advantage in producing a good over another country if it requires fewer resources to produce that good. Since one hour of labour time produces 0.5 units of wheat in country X against 0.4 units in country Y. Therefore, Country X has absolute advantage in production of wheat.

iii. Since one hour of labour time produces 1.0 units of rice in country Y against 0.25 units in country X.

Therefore, Country Y has absolute advantage in production of cloth.

Question 39.

i. What's meant by Foreign Portfolio investment?

ii. Explain the Real Exchange Rate.

Answer :

i. **Foreign Portfolio Investment:** Foreign portfolio investment is the flow of 'financial capital' rather than 'real capital' and does not involve ownership or control on the part of the investor.

   Examples of foreign portfolio investment are the deposit of funds in an Indian or a British bank by an Italian company or the purchase of a bond (a certificate of indebtedness) of a Swiss company or of the

   Swiss government by a citizen or company based in France. Unlike FDI, portfolio capital, in general, moves to investment in financial stocks, bonds and other financial instruments and is effected largely by individuals and institutions through the mechanism of capital market. These flows of financial capital have their immediate effects on balance of payments or exchange rates rather than on production or income generation.

ii. **Real Exchange Rate:** The' real exchange rate' describes 'how many' of a good or service in one country can be traded for 'one' of that good or service in a foreign country. It is calculated as :

   Real exchange rate = Nominal exchange rate X Domestic price Index /Foreign price Index

   Real Exchange Rate (RER) incorporates changes in prices.

Question 40.

Please refer to the table below.

i. Which of the three exporters engage on anticompetitive act in the international market while pricing its export of goods X to Country D?

ii. What would be effect of such pricing on domestic producers of Good X? Advise remedy available for country D?

Good X	Country A(In $)	Good X(In $)	Country A(In $)
Average Cost	30.5	29.4	30.9
Price per unit for domestic sales	31.2	31.1	30.9
Price Charged in Country D	31.9	30.6	30.6

Answer :

i. Dumping by Country B and Country C. B because it sells at a lower price than that in domestic market; Country C because it is selling at a price which is less than the average cost of production.

ii. Adverse effects on domestic industry as they will lose competitiveness in their markets due to unfair practice of dumping. Country D may prove damage to domestic industries and charge anti-dumping duties on goods imported from Country B and Country C so as to raise the price and make it at par which similar goods produced by domestic firms.

Question 41.

Define quantitative restrictions? Are QRs allowed under the WTO? What are the exceptions?

Answer :

Quantitative restrictions are limits or quotas imposed by importing / exporting countries on the amount or value of particular products that can be imported or exported from one country to another during a given period. For example, an import quota. Article XI of GATT 1994 prohibits the use of QRs (though there are certain exceptions) to this rule.

In certain circumstances, however, quotas, export or import licenses or other similar measures are allowed, e.g.:

i. QRs temporarily imposed for prevention or relief of critical food shortages

ii. QRs necessary to the application of standards or regulations for goods, classification, grading or making of commodities in international trade.

iii. Import restrictions on any agricultural or fisheries products necessary to enforcement of governmental measures which operate to achieve specified purposes.

Question 42.

What are the objectives of the Agreement on Agriculture (AOA)?

Answer :

The Agreement on Agriculture (AoA) is an international treaty of the World Trade Organization negotiated during the Uruguay Round.

It contains provisions in three broad areas of agriculture and trade policy: market access, domestic support and export subsidies. The Agreement aims to:

i. establish fair and market oriented agricultural trading system, and

ii. provide for substantial and progressive reduction in agricultural support and export subsidies with a view to remove distortion in the world market. These are to be achieved through enhancement of market access, reduction of domestic support and elimination of export subsidies.

Question 43.

"World Trade Organisation (WTO) has a three-tier system of decision making."Explain.

Answer :

The World Trade Organization has a three- tier system of decision making. The WTO's top level decision-making body is the Ministerial Conference which can take decisions on all matters under any of the multilateral trade agreements.

The Ministerial Conference meets at least once every two years. The next level is the General Council which meets several times a year at the Geneva headquarters.

The General Council also meets as the Trade Policy Review Body and the Dispute Settlement Body. At the next level, the Goods Council, Services Council and Intellectual Property (TRIPS) Council report to the General Council. These councils are responsible for overseeing the implementation of the WTO agreements in their respective areas of specialisation. The three also have subsidiary bodies.

Numerous specialized committees, working groups and working parties deal with the individual agreements.

Question 44.

Examine why General Agreement in Tariff & Trade (GATT) lost its relevance.

Answer :

The GATT lost its relevance by 1980s because:

- It was obsolete to the fast evolving contemporary complex world trade scenario characterized by emerging globalisation
- International investments had expanded substantially
- Intellectual property rights and trade in services were not covered by GATT
- World merchandise trade increased by leaps and bounds and was beyond its scope
- The ambiguities in the multilateral system could be heavily exploited
- Efforts at liberalizing agricultural trade were not successful
- There were inadequacies in institutional structure and dispute settlement system
- It was not a treaty and therefore terms of GATT were binding only insofar as they are not incoherent with a nation's domestic rules

Question 45.

Explain the principle motivations of a country seeking FDI?

Answer :

Motivations for a country seeking investments occurs when:

i. Producers have saturated sales in their home market

ii. Firms want to ensure market growth and to find new buyers and larger markets with sizable population.

iii. Technological developments and economies arising from large scale production necessitate greater ability of the market to support the expected demand on which the investment is based. The minimum size of market needed to support technological development in certain industries is sometimes larger than the largest national market.

iv. There are substantial barriers to exporting from the home country

v. Firms identify country-specific consumer preferences and favourable structure of markets elsewhere.

vi. Firms realize that their products are unique or superior and that there is scope for exploiting this opportunity by extending to other regions.

Question 46.

How does the WTO agreement ensure market access?

Answer :

The principal objective of the WTO is to facilitate the flow of international trade smoothly, freely, fairly and predictably. The WTO agreement aims to increase world trade by enhancing market access by the following:

i. The agreement specifies the conduct of trade without discrimination. The Most-favoured-nation (MFN) principle holds that if a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all other WTO members.

ii. The National Treatment Principle requires that a country should not discriminate between its own and foreign products, services or nationals. With respect to internal taxes, internal laws, etc. applied to imports, treatment not less favourable than that which is accorded to like domestic products must be accorded to all other members.

iii. The principle of general prohibition of quantitative restrictions.

iv. By converting all non- tariff barriers into tariffs which are subject to country specific limits.

v. The imposition of tariffs should be only legitimate measures for the protection of domestic industries, and tariff rates for individual items are being gradually reduced through negotiations‘ on a reciprocal and mutually advantageous’ basis.

vi. In major multilateral agreements like the Agreement on Agriculture (AOA), specific targets have been specified for ensuring market access.

Question 47.

What is Arbitrage? What is the outcome of Arbitrage?

Answer :

Arbitrage refers to the practice of making risk-less profits by intelligently exploiting price differences of an asset at different dealing places. On account of arbitrage, regardless of physical location, at any given moment, all markets tend to have the same exchange rate for a given currency.

Question 48.

How does trade increase economic efficiency and which view argued that trade is a zero- sum game and how?

Answer :

Economic efficiency increases due to quantitative and qualitative benefits of extended division of labour, economies of large scale production, betterment of manufacturing capabilities, increased competitiveness and profitability by adoption of cost reducing technology and business practices and decrease in the likelihood of domestic monopolies. Efficient deployment of productive resources - natural, human, industrial and financial resources ensures productivity gains.

Mercantilist argued that trade is a zero sum game. Mercantilism advocated maximizing exports in order to bring in more precious metals and minimizing imports through the state imposing very high tariffs on foreign goods. This view argues that trade is a 'zero-sum game', with winners who win does so only at the expense of losers and one country's gain is equal to another country's loss, so that the net change in wealth or benefits among the participants is zero.

Question 49.

What are the main advantages of fixed rate regime in an open economy?

Answer :

In an open economy, the main advantages of a fixed rate regime are, **firstly**, a fixed exchange rate avoids currency fluctuations and eliminates exchange rate risks and transaction costs that can impede international flow of trade and investments. A fixed exchange rate can thus greatly enhance international trade and investment.

Secondly, a fixed exchange rate system imposes discipline on a country's monetary authority and therefore is more likely to generate lower levels of inflation.

Thirdly, the government can encourage greater trade and investment as stability encourages investment.

Fourthly, exchange rate peg c an also enhance the credibility of the country's monetary policy. And

lastly, in the fixed or managed floating (where the market forces are allowed to determine the exchange rate within a band) exchange rate regimes, the central bank is required to stand ready to intervene in the foreign exchange market and, also to maintain an adequate amount of foreign exchange reserves for this purpose.

Question 50.

What do you understand by the term 'Most-Favored-Nation' (MFN)?

Answer :

When a country enjoys the best trade terms given by its trading partner it is said to enjoy the Most Favoured Nation (MFN) status. Originally formulated as Article 1 of GATT, this principle of non-discrimination states that any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be extended immediately and unconditionally to the like product originating or destined for the territories of all other contracting parties. Under the WTO agreements, countries cannot normally discriminate between their trading partners. If a country improves the benefits that it gives to one trading partner, (such as a lower a trade barrier, or opens up a market), it has to give the same best treatment to all the other WTO members too in respect of the same goods or services so that they all remain 'most-favoured'. As per the WTO agreements, each member treats all the other members equally as "most-favoured" trading partners.