ECONOMICS

[Time allowed: 3 hours] [*Maximum marks:100]*

General Instructions :

(i) ***All*** *questions in both the sections are compulsory.*

(ii) *Marks for questions are indicated against each.*

(iii) *Questions Nos.* ***1-5*** *and* ***17-21*** *are very short-answer questions carrying* ***1*** *mark each. They are required to be answered in* ***one sentence*** *each*

(iv) *Questions Nos.* ***6-10*** *and* ***22-26*** *are short-answer questions carrying* ***3*** *marks each. Answers to them should normally not exceed* ***60*** *words each.*

(v) *Questions Nos.* ***11-13*** *and* ***27-29*** *are also short-answer questions carrying* ***4*** *marks each. Answers to them should normally not exceed 70 words each.*

(vi) *Questions Nos.* ***14-16*** *and* ***30-32*** *are long-answer questions carrying* ***6*** *marks each. Answers to them should normally not exceed* ***100*** *words each.*

(vii) *Answers should be brief and to the point and the above word limits should be adhered to as far as possible.*

SECTION B

17. Given meaning of managed floating exchange rate. **(1)**

Ans. Managed floating system is combination of two systems–fixed and floating. It calls for government or central bank to intervene when the need for the same is realised. This is done with the help of purchase and sell of foreign currency to moderate exchange rate movements.

18. Define a Tax. **(1)**

Ans. Taxes are the compulsory payments made by the households and the producing sectors to the government. Taxes are of two types namely, direct taxes (such as income tax) and indirect taxes (such as, sales tax).

19. Define Stock variable. **(1)**

Ans. Stock variables are those variables that are measured at a particular point of time. These variables have no time dimensions. For example, bank balance as on 1st Oct, 2011 is Rs,5000.

20. Define capital goods. **(1)**

Ans. Capital goods are those goods which are used for the production process several times, and add to the productive capacity and to the capital stock of the country. For example, plant and machinery, etc.

21. What are demand deposits? **(1)**

Ans. These are money deposits made by the accountholders of a bank. The accountholders can demand these deposits at any point of time as per their discretion and convenience.

22. Calculate Net Value Added at Factor Cost: **(3)**

(i)	Consumption of fixed capital (Rs)	600
(ii)	Import duty (Rs)	400
(iii)	Output sold (units)	2,000
(iv)	Price per unit of output (Rs)	10
(v)	Net change in stock (Rs)	(–) 50
(vi)	Intermediate cost (Rs)	10,000
(vii)	Subsidy (Rs)	500

Ans. NVA_{FC} = Sales + Change in Stock – Intermediate Cost – Consumption of Fixed Capital – Net Indirect Taxes

Sales = Quantity × Price

= 2000 × 10 = Rs 20,000

Net Indirect taxes = Taxes – subsidy

= Import duty – subsidy

= Rs 400 – 500 = (– 100)

$\therefore NVA_{FC}$ = 20,000 + (–50) – 10,000 – 600 – (–100)

= 20,000 –50 – 10,000 – 600 + 100

= Rs 9450 crore

23. Distinguish between Revenue Expenditure and Capital Expenditure in a government budget. Give example. **(3)**

Or

Explain the role of government budget in allocation of resources.

Ans.

Basis	Revenue Expenditure	Capital Expenditure
Creation of Assets	It does not create assets for the government.	It results in the creation of assets.
Reduction of Liability	These expenditures do not result in the reduction of liability.	These expenditures cause a reduction of the liability of the government.
Items	(a) Aids given to states and others (b) Interest payments (c) Expenditure on defence	(a) Purchase of shares (b) Expenditure on land, building, etc. (c) Grants by the central government to the state government

Or

Private enterprises generally have a tendency to allocate resources to only those areas of production which are economically feasible and profitable. They are not guided by the service or welfare motive; in fact they are guided by the price signals. Budgetary policy of the government implies taxation and subsidies policy. Government through its budgetary policy, levies taxes on the richer income group and transfer purchasing power and enhances welfare of the poor section of society. Thus, the government through its budgetary policy allocates resources in such a manner as to maintain a balance between the profit motive and social welfare.

24. Explain the significance of the 'Store of Value' function of money. **(3)**

Ans. The function of money as store of value explains the importance of money as value storage. This implies that wealth in the form of money can be stored easily as a medium of exchange for future use. For example, money can be stored in banks for meeting emergency and future needs. The importance of the money as store of value is explained in the following points.

1. As in the barter system, it was very difficult to store goods, especially perishable goods (fruits, meat, etc.) for the purpose of value storage. This limitation of barter system is overcome by the money due to its potential to store value.
2. Secondly, the contractual or future payments were very difficult to be made in barter system. For example, a worker working on contract basis could not be paid in terms of rice or chairs. Money helped people to demand and forward loans and to make future and deferred payments along with interests.

25. Find 'investment' from the following: **(3)**

National	=	Rs 500
Autonomous Consumption	=	Rs 100
Marginal propensity to consume	=	0.75

Ans. At equilibrium

$y = c + I$

or, $y = \bar{c} + by + I$ where b = MPC

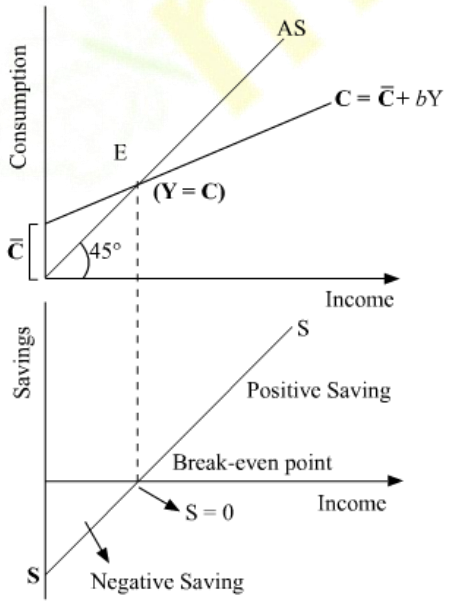
500 = 100 + (0.75 × 500) + I

500 – 100 – 375 = I

∴ Investment = Rs 25

26. Outline the steps taken in deriving saving curve from the consumption curve. Use diagram. **(3)**

Ans.



In the diag. $\overline{C} + bY$ is the consumption curve.

The 45° line is the aggregate supply curve.

At point E, consumption = income ie (Y = C)

$\overline{C}$ represents the autonomous consumption i.e. consumption at zero level of income. Corresponding to $\overline{C}$ in the consumption function we have $-\overline{C}$ in the saving function. Ie there are negative savings equal to autonomous consumption at Y = 0. At point E_1 (Y = C) This implies that all the income is spent on consumption expenditure. Thus savings equal to zero. Connecting points S_1 and Y we put the saving function.

27. Giving reason explain how should the following be treated in estimating national income: **(4)**
(i) Payment of bonus by a firm
(ii) Payment of interest on a loan taken by an employee from the employer

Ans. **(i) Payment of bonus by a firm**:
Payment of bonus by a firm will be included in the national income because it is a part of the compensation of employees (while estimating national income by Income Method).

(ii) Payment of interest on loan taken by employee from the employer:
Payment of interest on loan taken by employee from the employer will be included in the national income because it is a part of operating surplus (by Income Method)

28. Explain 'revenue deficit' in a Government budget? What does it indicate? **(4)**

Ans. Revenue deficit is the difference between government's revenue expenditure and government's receipts.
Revenue Deficit = Revenue Expenditure – Revenue Receipts

Indication of Revenue Deficit

The indication of the revenue deficit is explained in the below mentioned points.
1. It reflects the government fiscal policy.
2. It indicates that government's borrowings to finance its consumption expenditures and revenue expenditures such as, payments to government employees, etc.
3. Revenue deficit implies unsoundness of the financial system of an economy.

An increase in revenue deficit implies a proportion increase in the fiscal deficit.

29. Explain the components of Legal Reserve Ratio. **(4)**

OR

Explain 'bankers' bank, function of Central bank.

Ans. Legal Reserve Ratio (LRR) refers to the minimum fraction of the total deposits which is legally compulsory for the commercial banks to keep as cash with themselves as per the RBI's guidelines. That is, in other words, this is the minimum the reserve requirements, wherein banks are liable to maintain reserves with the central bank.

The two main components of LRR are as follows.

(i) Cash Reserve Ratio (CRR)

It refers to the minimum amount of funds that a commercial bank has to maintain with the Reserve Bank of India, in the form of deposits. For example, suppose the total assets of a bank are worth Rs.200 crores and the minimum cash reserve ratio is 10%. Then the amount that the commercial bank has to maintain with RBI is Rs.20 crores. If this ratio rises to 20%, then the reserve with RBI increases to Rs.40 crores. Thus, less money will be left with the commercial bank for lending. This will eventually lead to considerable decrease in the money supply. On the contrary, a fall in CRR will lead to an increase in the money supply.

(ii) Statuary Liquidity Ratio (SLR)

SLR is concerned with maintaining the minimum reserve of assets with RBI, whereas the cash reserve ratio is concerned with maintaining cash balance (reserve) with RBI. So, SLR is defined as the minimum percentage of assets to be maintained in the form of either fixed or liquid assets with RBI. The flow of credit is reduced by increasing this liquidity ratio and vice-versa. In the previous example, this can be understood as rise in SLR will restrict the banks to pump money in the economy, thereby contributing towards decrease in money supply. The reverse case happens if there is a fall in SLR, as it increases the money supply in the economy.

OR

The central bank being the apex bank of a country, serve as a banker to all the commercial banks in the country. The reserves of the commercial banks are held by the central bank. These reserves serve as a pool from which the central bank advances money to the commercial banks in times of financial crisis. The central bank supervises, regulates the commercial banks and helps them in case of any financial exigencies.

30. Find out (a) Net National Product at Market price and (b) Gross National Disposable Income: **(6)**

		(Rs crore)
(i)	Net current transfers from abroad	(–) 10
(ii)	Wages and Salaries	1,000
(iii)	Net factor income to abroad	(–) 20
(iv)	Social security contributions by employers	100
(v)	Net Indirect Tax	80
(vi)	Rent	300
(vii)	Consumption of fixed capital	120
(viii)	Corporation Tax	50
(ix)	Dividend	200
(x)	Undistributed profits	60

(xi) Interest 400

Ans. (a) Net National Product of Market Price = Wages and salaries + Social security contributions by employers + Rent + Dividend + Corporation Tax + Undistributed Profits + Interest – Net Factor Income from Aborad + Net Indirect Taxes
= 1000 + 100 + 300 + 200 + 50 + 60 + 400 – 20 + 80
= Rs 2,170 crore

(b) Gross National Disposable Income = Net National Product at Mark Price – Net Current transfers from abroad + Consumption of fixed capital
= 2170 – 10 + 120
= Rs 2,280 crore

31. Explain the distinction between autonomous and accommodating transaction in balance of payments. Also explain the concept of balance of payment 'deficit' in this context. **(6)**

Ans. Autonomous items refer to those economic transactions which are motivated by profit consideration. For example, imports and exports of goods and services and inflow and outflow of capital due to the interest differentials. Autonomous items are referred to as 'items above the line' in BoP. These items when included in the accounts do not affect BoP of a country.
Those transactions that take place due to some other motive (except profit earning) are termed as accommodating items of BoP. These items are use to correct BoP disequilibrium. For example, government financing, injecting or withdrawing from official reserves through special drawing rights and foreign exchange reserves. They are often referred as 'below the line items'

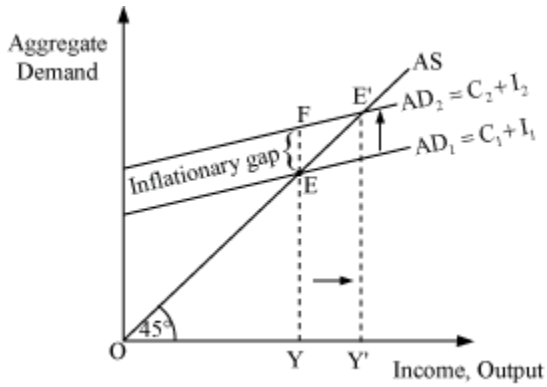
BoP deficit refers to a situation where imports exceed exports. In other words, it can be said that BoP is in deficit when autonomous receipts are less than the autonomous payments. Since accommodating transactions are determined by a net consequence of autonomous items, in case of a deficit accommodating transactions are incurred by the government, so as to balance the autonomous deficit.

32. Explain the concept of 'excess demand' in macroeconomics. Also explain the role of 'open market operation' in correcting it. **(6)**

OR

Explain the concept of 'deficient demand' in macroeconomics. Also explain the role of Bank Rate in correcting it.

Ans. Excess demand is a situation when Aggregate Demand (AD) is more than the Aggregate supply (AS) corresponding to the full employment level. That is,
$AD > AS$ [Corresponding to full employment]



Inflationary gap = Excess demand $= AD_2 - AD_1 = FE$

Excess demand causes factor prices to rise and thus increases the cost of production. This in turn raises the prices of the goods and services in the economy. Thus, it leads to a situation of wage-price spiral, where wages tend to catch the rising prices, which again raises the price and so on. Therefore, due to excess demand a economy has a tendency to deviate from the point of economic stability.

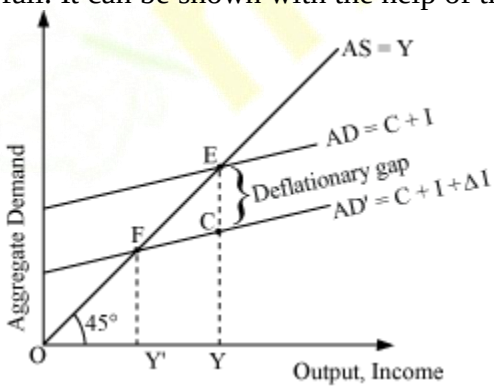
In order to curb the problem of excess demand, the government can opt for open market operations (OMO). It refers to buying and selling of government securities in the open market. In situation of excess demand, the government needs to reduce the cash balances in the economy. Thus it sells securities in the open market, which reduces the purchasing power and consequently, has a reducing impact on the AD.

OR

Deficient demand is a situation that occurs when aggregate demand (AD) falls short of aggregate supply (AS) corresponding to full employment in the economy.

That is, AD < AS [corresponding to full employment]

It gives rise to deflationary gap, which causes the economy's income, output and employment to fall. It can be shown with the help of the following figure.



The *x*-axis measures the level of output and income whereas *y*-axis shows the consumption, investment and AD. OY is the full employment level of output and income. EY shows the aggregate demand at full employment level. AD′ indicates unemployment level of AD. The vertical difference between AD and AD′ shows deficiency of demand for achieving full

employment. Deficiency of demand (EC) denotes deflationary gap. At equilibrium point F, AD′ intersects the 45° line, the equilibrium output is OY′, which is below the full employment level OY. Hence, Y′Y denotes unemployment.

Deflationary Gap = Deficient demand

=AD – AD′

= EC

Bank Rate refers to the rate at which the central bank lends to the commercial banks. In case of deficit demand, the central bank lowers the Bank Rate. Subsequently, the commercial banks lower their market rate of interest. This increases the demand for credit and consequently, leads to rise in the consumption and investment expenditure, increasing the aggregate demand.