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## PART - A

1 Q.i **Who wrote the book "Principles of Economics"?** [1]

**Ans.** Alfred Marshall wrote the book "Principles of Economics."

**Q.ii Define price elasticity of demand.** [1]

**Ans.** Price elasticity of demand is percentage change in demand divided by percentage change in price.

Def: According to Marshall "Price elasticity of demand is the ratio of percentage change in quantity demanded to a percentage change in price".

$$\text{Price elasticity} = \frac{\text{percentage change in } Q \text{ demanded}}{\text{percentage change in Price}}$$

**Q.iii What is Revenue?** [1]

**Ans.** By selling a commodity what a firm gets is called its revenue.

Def : In the words of Dooley "The revenue of a firm is its sales receipts or money receipts from the sale of a product.

**Q.iv What is utility?** [1]

**Ans.** Utility is the want satisfying power of a good. If you are thirsty you can quench your thirst by drinking water. This power of water is called utility. According to Hibbdon "Utility is the ability of a good to satisfy a want".

**Q.2 Write the main assumptions of Production possibility curve.** [2]

**Ans.** It is a curve showing alternative production possibilities of two goods with the given resources and technique of production. It is also called production possibility boundary or frontier because it shows the limit of what it is possible to produce with present resources. This curve is also called Transformation Line or Transformation Curve because it indicates that if more of good - X is to be produced then factors will have to be withdrawn from the production of good - Y and transferred to the production of good - X. In other words, good- Y is transformed into good X.

### Definition

In the words of Samuelson, "Production possibility curve is that curve which represents the maximum amount of a pair of goods or services that can be produced with an economy's given resources and technique assuming that all resources are fully employed".

Production possibility curve shows different combinations of a pair of goods which can be produced with the given resources on the assumptions that (i) resources are fully and efficiently Utilised, and (ii) technique remains constant.

### Assumptions

The concept of production possibility curve is based on the following assumptions:

(1) Fixed Quantity of Factors of Production : Amount of factors of production is fixed. However, they can be transferred from one use to the other, to some extent.

(2) Fuller and Efficient Utilisation of the Available Resources : All available resources in the economy are being utilised fully and efficiently.

(3) Constant Technology: Technique of production remains constant that is, there is no change in it.

(4) Two Goods : To simplify the study it is assumed that only two goods or two sets of goods are produced in the economy; like wheat and cloth or capital goods and consumer goods.

**Q.3 Define two difference between average production and marginal production. [2]**

Ans.	Average Product	Marginal Product
1.	It is per unit production	It is change in total product due to application of one more or less unit
2.	$MP = \frac{\Delta TP}{\Delta L}$	$AP = \frac{TP}{L}$

**Q.4 Why the demand curve slopes downward? [3]**

**Ans.** The demand curve slopes downwards because of the following points.

**(1) Law of Diminishing Marginal Utility :** According to this law, as a consumer, in a given time, increases the consumption of unit goes on diminishing, the utility from each successive unit goes on diminishing. A consumer gets maximum satisfaction when the price of a commodity is equal to its marginal utility. As more units are bought, their marginal utility diminishes. Consequently, a consumer will buy more and more units of a commodity only when he has to pay less and less price for each successive unit. It is, therefore, clear that with fall in price, more units of a commodity will be demanded and with rise in price, less units of a commodity will be demanded.

**(2) Income Effect :** Income effect is the effect on the change in the quality demanded when the real income of buyer changes as a result of the change in the price of commodity - alone. Change in the price of a commodity causes a change in the real income of the consumer. Real income is that income which is measured in terms of goods and services. With fall in price, real income increases. It means that with the same money income, more goods and services can be purchased. The increased real income is used to buy more units of the commodity. Thus, demand extends with increase in real income. Conversely, rise in price leads to fall in real income and hence, contraction of demand.

**(3) Substitution Effect :** Substitution effect refers to substitution of one commodity for the other when it becomes relatively cheaper. Thus, when the price of commodity - X falls, it becomes cheaper in relation to commodity - Y. Accordingly, X is substituted for Y. Tea and coffee are substitutes, with fall in the price of tea, it is substituted for coffee. It is called substitution effect. As a result of this effect, a consumer, in order to get maximum satisfaction, will buy more units of that commodity whose price has fallen in relation to the substitute commodity. In the above example, consumers will substitute tea for coffee and so demand

for tea will extend under substitution effect. Conversely, if the price of tea rises, consumer will substitute coffee for tea and hence demand for coffee will extend.

**(4) Size of Consumer Group :** When the price of a commodity falls, many consumers who were not buying it at its previous price begin to buy it. Consequently, demand extends. Conversely, when the price rises, some of the consumers will be unable to buy the commodity and thus demand will fall. In this way, change in price is followed by change in the size of consumer group or number of consumers which in turn, will influence the total demand for the commodity.

**Q.5 Complete the following table :** [3]

Units of Production (Q)	Total Revenue (Rs.) (TR)	Average Revenue (Rs.) (AR)	Marginal Revenue (Rs.) (MR)
1	-	20	-
2	-	16	-
3	-	12	-
4	-	8	-

**Ans.**

Units of Production Q	TR (Rs.)	AS (Rs.)	MR (Rs.)
1	20	20	20
2	32	16	12
3	36	12	4
4	48	8	12

$$TR = AR \times Q$$

$$MR_n = TR_n - TR_{n-1}$$

**Q.6 Find elasticity of supply :** [3]

Price (Rs.)	Supply (kg.)
10	30
12	40

**Ans.**

$$E_s = \frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

$$= \frac{Q_1 - Q}{P_1 - P} \times \frac{P}{Q}$$

$$= \frac{40 - 30}{12 - 10} \times \frac{10}{30}$$

$$= \frac{10}{2} \times \frac{10}{30} = \frac{1}{3}$$

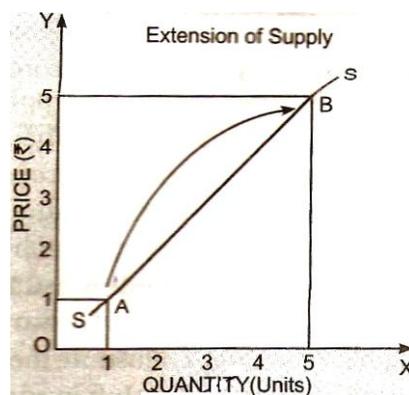
Q.7 What do you mean by extension of supply and increase in supply.

[3]

Ans. (1) Change in Quantity Supplied Extension and Contraction of Supply or Movements along a Supply Curve

Increase in quantity supplied of a commodity due to rise in its price is called Extension of supply and decrease in quantity supplied due to fall in its price is called Contraction of Supply. Diagrammatically, extension and contraction of supply are reflected on the same supply curve. Therefore, these are also called movements along the supply curve. illustrate the situation of extension of supply. Table and Fig. illustrate the situation of contraction of supply.

Price of Ice Cream (Rs.)	Quantity Supplied (units)	Description
1	1	Rise in Price
5	5	Extension of Supply



In table, it is shown that when price of ice cream is Rs. 1, the quantity supplied is of 1 unit of ice cream. When price rises to Rs. 5, the supply extends to 5 units. In Fig. SS is the supply curve of ice cream. When price of ice cream is Rs. 1 supply is of 1 ice cream, The producer is at point 'A' on the supply curve. When price rises to Rs. 5, the supply extends to 5 units. The producer moves from point 'A' to point 'B' on the same supply curve. Thus, movement from the lower point to the higher point on the same supply curve is called extension of supply.

(2) Change in Supply: Increase and decrease in Supply or shift in Supply Curve

Increase in supply occurs when quantity supplied increases at the existing price of the commodity. Diagrammatically, it means a forward shift in supply curve. On the other hand, decrease in supply occurs when quantity supplied decreases at the existing price of the commodity. Diagrammatically, it means a backward shift in supply curve. Both, increase and decrease in supply are caused by factors other than own price of the commodity. Table and Fig., illustrate the situations of increase in supply or forward shift in supply curve. Table and fig., illustrate the situations of decrease in supply or backward shift in supply curve.

Price of Good-X (₹)	Quantity Supplied of Good-X (Units)
10	20
10	30

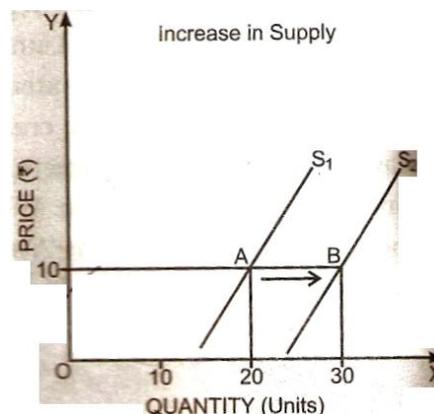


Table shows that initially 20 units of the commodity are supplied at the price of Rs. 10 per unit. Owing to some causes (generally related to reduction in the cost of production), firms are now willing to supply 30 units even when price of remains to be Rs. 10 per unit. Diagrammatically, it implies a forward shift in supply curve (or shift to the right) as from  $S_1$  to  $S_2$  in Fig. Producer (s) tend to shift from point A on  $S_1$  to point B on  $S_2$ .

**Q.8 What is meant by monopoly market? Explain its four characteristics. [4]**

**Ans.** It is that situation of market in which there is a single seller of product with no close substitutes in the market. It is explained with the help of few examples:

Suppose, there is only one firm dealing in the sale of cooking gas in your town. You get your electricity supply from one agency, that is Electricity Board; You can travel by railways owned, controlled and run by Government of India alone. All these are example of monopoly. This situation of market, where a single (Mono) firm controls (Poly) the production of a commodity, is called of 'Monopoly'. Hence, monopoly is a market situation in which there is only one producer of a commodity with no close substitutes.

### Definition

In the words of Koutsoyiannis, "Monopoly is a market situation in which there is single seller, there are no close substitutes for commodity it produces, there are barriers to entry".

### Features of Monopoly

The main features of monopoly are as follows :

- (1) One Seller and Large Number of Buyers : Under monopoly, there should be a single producer of a commodity. Thus, there is only one firm under monopoly. But the buyers of the product are in large number. Consequently, no buyer can influence the price of the product.
- (2) Pure Monopoly is also an Industry : Since under monopoly situation, there being only one firm, the distinction between firm and industry no longer exists. There is no difference between the study of a monopoly firm and industry.
- (3) Restrictions on the Entry of the New Firms : Under monopoly, there are some restrictions on the entry of new firms into monopoly industry. As for instance, there are patent rights or exclusive control over a technique or raw material.

(4) Full Control Over Price : Since he alone produces the commodity in the market, a monopolist has full control over its price. A monopolist thus, is a price maker. He can fix whatever price he wishes to fix for his product.

**Q.9 Distinguish between return to a factor and return to scale. [4]**

**Ans. Following are the main differences between returns to a factor and returns to scale**

**(1) Type of Production Function :** Returns to a factor are studied with reference to 'variable proportions' type production function, whereas returns to scale are studied with reference to 'constant proportions' type production function.

**(2) Number of Variable Factors :** Returns to a factor apply when one factor alone is variable and other factors remain fixed. Returns to scale apply when all factors of production are variable.

**(3) Scale of Production :** Returns to a factor are studied on the assumption that the scale of production does not change. In case of returns to scale, the scale of production ought to change.

**(4) Factor Ratio :** Returns to scale are studied on the assumption that factor - ration remains constant. In case of returns to a factors, factor - ration ought to change.

**(5) Time period :** Returns to scale is only a long period possibility, returns to a factor and often studied with reference to short period.

**Q.10 Define market demand. Explain the factors effecting it. [5]**

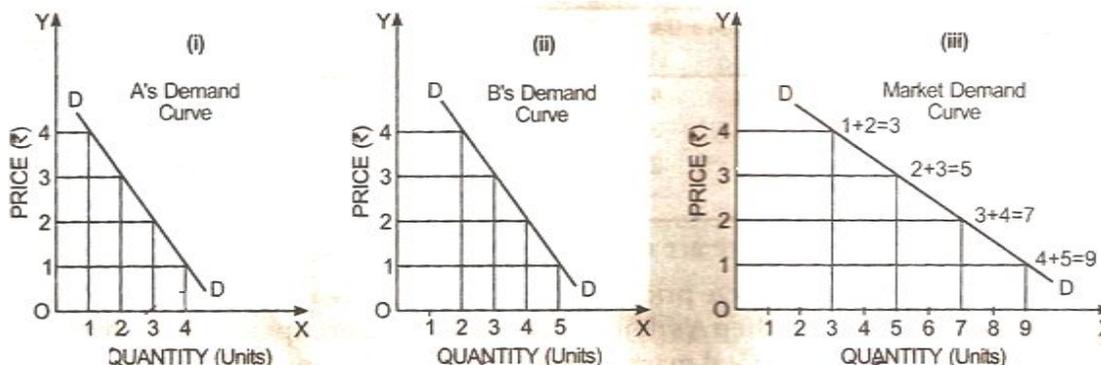
**Ans. Market Demand Shedule :** In every market, there are severlconsumers of commodity, say ice cream. Market demand schedule is one that shows total demand of all the consumers in the market at different prices of the commodity during a period of time. On the assumption that there are only 2 buyers in the market, market demand schedule for (say) ice cream may be drawn as under :

Price of Ice Cream (₹)	A's Demand (1)	B's Demand (2)	Market Demand (3) (1+2)
1	4	5	4 + 5 = 9
2	3	4	3 + 4 = 7
3	2	3	2 + 3 = 5
4	1	2	1 + 2 = 3

The schedule shows that when price of ive cream rises its market demand falls. For example, when price is Rs. 1 then A's demand is for 4 ice cream cups and B's demand is for 5 ice cream cups. Thus, the total market demand at Rs. 1 is 9 cups of ive cream. But when price rises to Rs. 2 per cup then market demand falls to 7 ice cream cups.

**Market Demand Curve**

This curve shows the total of quantities of a commodity demanded by all the consumers in the market at different prices. It is the horizontal summation of the individual demand curves. In Fig., market demand curve has been drawn on the basis of table.



### Market Demand Function

Market demand function shows how market demand for a commodity (or aggregated demand for a commodity in the market) is related to its various determinants. Or, it shows the relationship between market demand for a commodity and its various determinants. It is expressed as under:

$$Mkt. D_x = f(P_x, P_r, Y, T, E, N, G, S, Y_d)$$

It will be read as :  $D_x$  : Market demand for commodity - X is a function (f) of  $P_x$  : Price of the commodity - X ;  $P_r$  : Price of related goods; Y : Consumers' income; T : Tastes and preferences E : Expectations; N : Population size and  $Y_d$  : Distribution of income.

Some of these factors like  $P_x, P_r, Y, T, E$  have already been discussed in the previous paragraph. We discuss below the remaining factors influencing market demand.

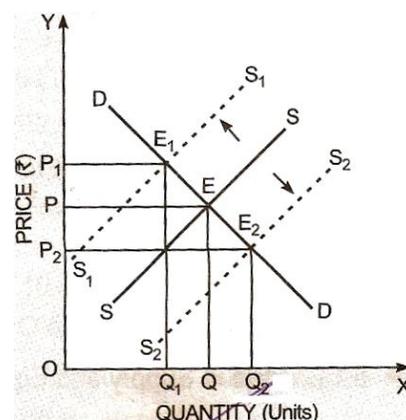
**(1) Population Size** : Demand increases with increase in population and decreases with decrease in population. This is because with the increase (or decrease) in population size, the number of buyers of the product tends to increase (or decrease). Composition of population also affects demand. If composition of population changes, e.g., female population increases, demand for goods meant for women will go up.

**(2) Distribution of Income** : Market demand is also influenced by the distribution of income in the society. If income is equally distributed, demand for a commodity is expected to be high. If income is not equally distributed, demand for a commodity is expected to be low. In case of unequal distribution, most people will not have enough money to buy things.

**Q.11 What will be the impact on price equilibrium when supply changes but demand remains constant?**

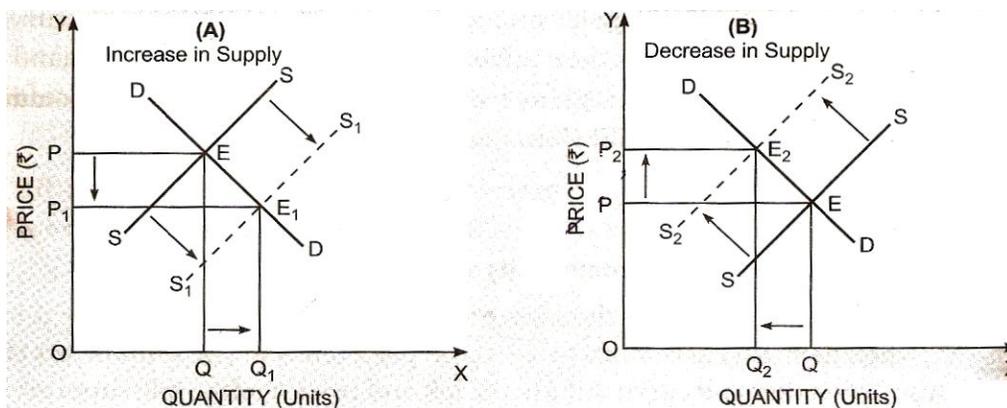
[5]

**Ans.** When demand for a commodity remains constant then, with an increase in supply, the equilibrium, price decreases and with decrease in supply, the equilibrium price increases. In Fig. DD is the initial demand curve and SS is the initial supply curve. OP is the initial equilibrium demand and supply, i.e. equilibrium quantity.



Let us suppose that due to increase in supply, the supply curve shifts to the right from  $SS$  to  $S_2S_2$ . The new supply curve  $S_2S_2$  intersects the demand curve  $DD$  at point  $E_2$ . Thus,  $E_2$  will be the new equilibrium point. At this point,  $OP_2$  and  $OQ_2$  will be the equilibrium price and equilibrium quantity respectively. Conversely, due to decrease in supply, the supply curve shifts to the left from  $SS$  to  $S_1S_1$ . The supply curve  $S_1S_1$  intersects the demand curve  $DD$  at point  $E_1$ . Therefore,  $E_1$  will be the new equilibrium point,  $OP_1$  will be the new equilibrium price and  $OQ_1$ , the new equilibrium quantity.

In briefly we can conclude that, when supply of a commodity increases, equilibrium price falls but the equilibrium quantity increases. On the other hand, when the supply of a commodity decreases, its equilibrium price rises and equilibrium quantity decreases. Fig. illustrates this situation.



**(1) Increase in Supply :** Fig. (A) shows that while demand remains unchanged due to increase in supply, the supply curve shifts downwards (rightwards) from  $SS$  to  $S_1S_1$ . The new supply curve  $S_1S_1$  intersects the demand curve at point  $E_1$ . Thus, new equilibrium point will be  $E_1$ . At point  $E_1$  the equilibrium price will fall from  $OP$  to  $OP_1$  and equilibrium quantity increases from  $OQ$  to  $OQ_1$ .

**(2) Decrease in Supply :** Fig. (B) shows that while demand remains unchanged due to decrease in supply, the supply curve will shift upwards (left wards) from  $SS$  to  $S_2S_2$ . The new supply curve  $S_2S_2$  intersects the demand curve at point  $E_2$ . At point  $E_2$ , the equilibrium price will increase from  $OP$  to  $OP_2$  and equilibrium quantity decreases from  $OQ$  to  $OQ_2$ .

**Q.12 Explain increase in demand and decrease in demand with the help of diagrams. [5]**

**Ans.** When quantity demanded of a commodity changes owing to a change in factors other than own price of the concerned commodity, it is a situation of increases or decrease in demand. It is shown by a shift in demand curve - forward or backward.

**(1) Increase in Demand**

When more of a commodity is purchased at its existing price, it is a situation of increase in demand. It is illustrated by Table and Fig.

Price of X (₹)	Quantity Demanded of X (Units)
10	20
10	30

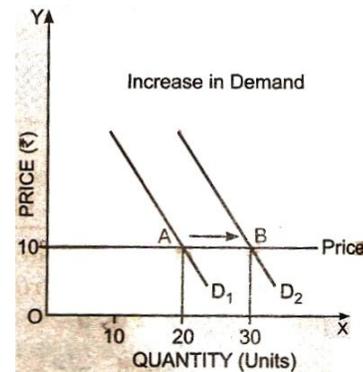


Table and Fig. 7 show that when price of the commodity is Rs. 10 per unit, 20 units are demanded. Even when price remains constant, consumers start demanding 30 units. It may be due to increase in their income or shift in tastes in favour of the commodity or other such factors. It is important to note that increase in demand is indicated by a shift in demand curve to the right, also called forward shift in demand curve. Fig. shows demand curve shifting from  $D_1$  to  $D_2$  when the consumers decide to buy 30 units (instead of 20) even when price of the commodity remains constant at Rs. 10 per unit. The consumer shift from point A on  $D_1$  to point B on  $D_2$ .

### Causes of increase in Demand

Important causes of increase in demand are as under :

- (i) When income of the consumer increases.
- (ii) When price of substitute good increases.
- (iii) When price of complementary good falls.
- (iv) When taste of the consumer shifts in favour of the commodity due to change in fashion or climate.
- (v) When price of the commodity is expected to increase in the near future.
- (vi) Increase in number of consumers, and
- (vii) When the income of the consumer is expected to increase in near future.

### (2) Decrease in Demand

When less of commodity is purchased at its existing price, it is a situation of decrease in demand. It is illustrated by Table and Fig.

Price of X (₹)	Quantity Demanded of X (Units)
10	30
10	20

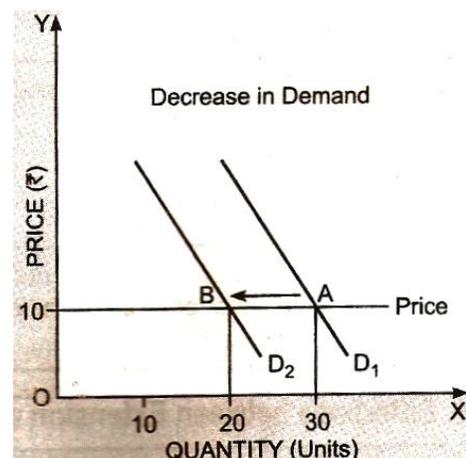


Table and Fig. show that when price of the commodity is Rs. 10 per unit, 30 units are demanded. Even when price remains constant, consumers decide to buy only 20 units. It may be due to decrease in their income or shift in tastes against the commodity or other such factors.

Decrease in demand is indicated by a shift in demand curve to the left, also called backward shift in demand curve. Fig. shows demand curve shifting from  $D_1$  to  $D_2$  when the consumers decide to buy only 20 units (instead of 30) even when price of the commodity remains constant at Rs. 10 per unit. The consumer shifts from point A on  $D_1$  to point B on  $D_2$ .

**Causes of Decrease in Demand**

Important causes of decrease in demand are as under :

- (i) When income of the consumer falls.
- (ii) When price of the substitute good decreases.
- (iii) When price of the complementary good increases.

OR

**(i) Write main conditions of consumer's equilibrium.**

**Ans. Purchase of a commodity by a consumer depends on three factors :**

- (i) Price of the commodity,
- (ii) Marginal (and total) utility of the commodity, and
- (iii) Marginal utility of money.

Let marginal utility of money for you = 4 utils (referring to your satisfaction from your standard set of goods available for a rupee).

Let X be the commodity you intend to buy.

Let  $P_X$  (Price of X) = Rs. 4

Marginal Utility Schedule of X is as follows:

**Diagrammatic Illustration**

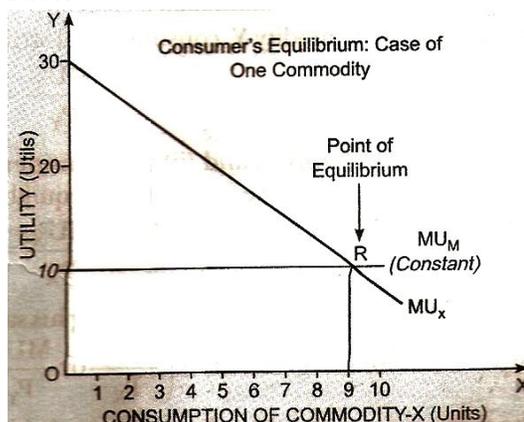


Fig. shows consumer equilibrium in a situation when he spends his given income only on one commodity.

X - axis of the diagram shows units of commodity - X consumed. Utility (utils) are shown on the Y - axis.

$MU_M$  is a horizontal straight line showing marginal utility of money or a rupee worth of satisfaction expected by the consumer (because  $MU_M$  is constant and it equal to 10 utils). The diagram is drawn on the assumption that  $P_X = Rs. 1$ . In such a situation, equilibrium occurs when  $MU_X = MU_M$ .

Consumer's Equilibrium : Two Commodities (or Several Commodities) case

Consider a situation when a consumer is buying commodities X and Y with his given income. How will he achieve his equilibrium? In case of any one commodity, say commodity - X, a consumer strikes his equilibrium when:

$$\frac{MU_X}{P_X} = MU_M \quad \dots\dots(i)$$

Likewise, for commodity - Y, consumer will strike equilibrium when :

$$\frac{MU_Y}{P_Y} = MU_M \quad \dots\dots(ii)$$

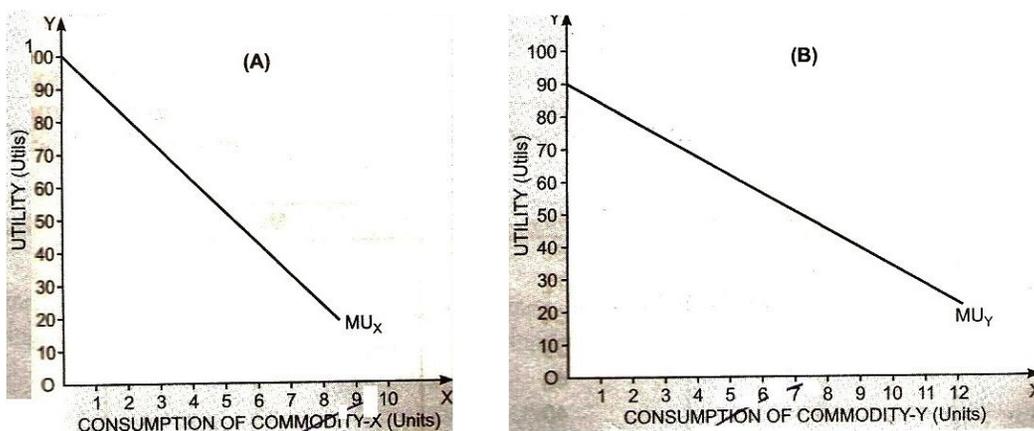
Combining equations (i) and (ii) and considering a situation when a consumer buys both commodities X and Y, can state his equilibrium as in the following equation :

$$\frac{MU_X}{P_X} \times \frac{MU_Y}{P_Y} = MU_M$$

It implies that a consumer is maximising his satisfaction from commodities X and Y when a rupee worth of marginal utility  $\frac{MU_X}{P_X}$  or  $\frac{MU_Y}{P_Y}$  is the same for commodities X and Y. It is the same as the marginal utility of money (which is rupee worth of satisfaction as defined by consumer himself). It further implies that, if  $P_X = P_Y$ , a consumer would strike his equilibrium when  $MU_X = MU_Y$ .

### Diagrammatic Illustration

Considering two commodities, X and Y fig. (A) shows  $MU_X$  and Fig. (B) shows  $MU_Y$ . The figure is based on the assumption that  $P_X = P_Y = Rs. 1$ .



We know the equilibrium is achieved when  $\frac{MU_X}{P_X} \times \frac{MU_Y}{P_Y} = MU_M$

(ii) Explain the concepts of private cost and social cost.

Ans. (1) Private Cost : Private cost is the cost incurred by an individual firm for producing a commodity. In the words of Miller, "Private costs incurred by the firm or the individual producer as a result of their own

decision." For example, the expenses incurred by a textile mill on the purchase of raw material, wages, rent, electricity charge, etc., to manufacture cloth are called private cost.

**(2) Social Cost :** Social cost is the cost incurred by the whole society for producing a commodity. For instance, during the process of manufacturing cloth the smoke emitting from the chimneys of textile mills spoils the garments worn by the people and so they have to spend more on laundry. Pollution of air tells upon the health of the people and they have to spend more on medical treatment. All these expenses are not incurred by a private firm but by the society as a whole. That is why these expenses are called social costs.

Following examples of social costs should make the distinction between private cost and social cost clear :

(i) The expenses incurred by a contractor in felling trees constitute private cost; but the sufferings that the society has to undergo in the form of soil erosion, floods, and deforestation constitute social cost.

(ii) Wastes of a chemical factory flowing into a river, not only pollute the river water but also cause death to the fish. In order to make this water potable, municipalities have to spend large amounts on water treatment. This expenditure constitutes social cost.

## **PART - B**

**Q.13 (i) Give one example of Macro -economics studies.**

**[1]**

**Ans.** Macro economics studies the behaviours of aggregates of the economy as a whole. Examples calculation of national income GDP, NNP, GNP.

**(ii) What is meant by spot market rate?**

**[1]**

**Ans.** Spot market is a financial market in which financial instruments or commodities are traded for immediate delivery. The price quoted for immediate settlement on a commodity is the spot rate.

**(iii) What is Tax?**

**[1]**

**Ans.** Tax is a compulsory payment to the government according to the prescribed laws. Taxes are of two types

(i) direct tax

(ii) indirect tax

**(iv) What is meant by open economy?**

**[1]**

**Ans.** Open economy is an economy in which there are economic activities between the domestic community and outside. It is one that engages in international exchange of goods and services and investments.

**Q.14 Distinguish between monetary and real flow of income.**

**[2]**

**Ans.**

Basis	Real flow	Money flow
Meaning	It refers to the flow of goods and services across different sectors of the economy.	It refer to the flow of money across different sectors of the economy.
Natura of transactions	It is flow of physical output among sectors.	It is flow of monetary transactions among sectors.
Nature of flow	It is also known as physical flow as either goods or services are exchanged among sectors	It is also known as nominal flow as only money is exchanged among sectors.

**Q.15 What is difference between Balance of Payment and Balance of Trade?**

**[2]**

**Ans.** (i) Balance of payments is a broad term. It includes balance of trade. Thus, balance of trade is a narrow term. It is a part of balance of payments.

(ii) Balance of trade includes exports and imports of goods or visible items alone. Balance of payments , on the contrary, includes all kinds of items, viz., goods, services, inflow/outflow of capital. It includes all visible and invisible items. In short, it can be said, balance of trade is , in fact, a part of balance of payments.

(iii) A country may have balanced or unbalanced balance of trade, but its balance of payments is always in balance.

(iv) In case of unfavourable balance of trade, its deficit can be met by balance of payments but deficit of balance of payments cannot be met by balance of trade.

(v) From the view point of economic analysis, balance of payments is more important than balance of trade. While formulating its foreign trade policy, every country, takes into consideration items of balance of payments. On its basis , one learns, that if a country's liabilities towards another country are large, then it will have great impact on the national income, level of employment and other economic policies of that country.

In short, the main difference between balance of trade and balance pf payments is that balance of trade is a partial record of international trade, whereas balance of payments is its complete record. Thus, balance of trade is a part of balance of payments.

**Q.16 If the MPS = 0.5 then find out the value of multiplier (K).**

**[2]**

**Ans.** MPS = 0.5

$$\begin{aligned}\text{Multiplier} &= \frac{1}{MPS} \\ &= \frac{1}{0.5} \\ &= \frac{1}{\frac{5}{10}} = \frac{10}{5} = 2\end{aligned}$$

**Q.17 Explain the instruments of Fiscal Policy to correct the Excess Demand. [3]**

**Ans.** Excess demand results in price rise or inflation in the economy.

Following fiscal measures are recommended to correct the inflationary situation:

**(1) Increase in Taxes :** Tax rates should be increased to reduce purchasing power of the people.

**(2) Decrease in Government Expenditure :** Government expenditure should be reduced on (i) health and education, (ii) public works programmes, (iii) maintenance of law and order, and defence of country, and (iv) the subsidies.

**(3) Reduction in Deficit Financing :** Deficit financing should be restricted. Because the printing of more notes would only increase the rate of inflation.

**(4) Increase in Public Debt or Borrowing :** Public borrowing should be increased, so that people are left with lesser purchasing power.

Thus, during periods of excess demand, the government should adopt the policy of surplus budget, increasing its revenue and decreasing its expenditure as much as possible.

**Q.18 Define flexible exchange rate. Write advantages and disadvantage of this system. [3]**

**Ans.** Flexible rate of exchange is that rate which is determined by the demand for and supply of the currencies concerned in the foreign exchange market. In other words, it is determined by the market forces, like the price of any other commodity. The market where foreign currencies are demanded and supplied is called foreign exchange market. It can therefore, be said that

$$R = f(D, S)$$

(Here, R: Exchange rate; D: Demand for different currencies in the international market; S : Supply of different currencies in the international market.)

The exchange rate at which demand for foreign currency is equal to its supply is called Per Rate of Exchange and it constitutes the Normal Rate or Equilibrium Rate. It is a flexible rate because it tends to change in accordance with changes in the supply of and demand for different currencies in the foreign exchange market.

### **Merits and Demerits of Flexible Exchange Rate System**

#### **Merits**

Following are the principal merits or advantage of flexible exchange rate system:

**(i) No Need for International Reserves :** Flexible exchange rate system is not to be supported with international reserves. Because member countries (in the flexible exchange rate system) are no longer floating 'convertible' currencies.

**(ii) Optimum Resource Allocation** : Flexible exchange rate system enhances efficiency in resource allocation. Accordingly, allocation of resources in the area of international trade, tends to become optimum.

**(iii) International Capital Movement** : Flexible exchange rate system enhances movement of capital across different countries of the world. This is due to the fact that member countries are no longer required to keep huge international reserves.

**(iv) Encouragement to Venture Capital** : Flexible exchange rate promotes venture capital in the foreign exchange market. Trading in international currencies itself becomes an important economic activity.

#### **Demerits**

But merits of flexible exchange rate system are not without its demerits. Following points may be noted in this regard :

**(i) Instability** : It causes instability in the international money market. Exchange rate tends to fluctuate like price of good in the commodity market.

**(ii) Instability in International Trade** : Instability in the foreign exchange market causes instability in the area of international trade. It becomes difficult to draw long - period policies of exports and imports.

**(iii) Macroeconomic Policies** : While fixed exchange rate helps coordination of macroeconomic policies, flexible exchange rate makes it a difficult proposition. Day - to - day fluctuation in exchange rate makes bilateral trade agreements a difficult exercise.

**Q.19 Find Gross National Product at market price from the following data:**

Items	Core Rs.
<b>(i) Net Domestic Product at factor cost</b>	<b>18000</b>
<b>(ii) Indirect Taxes</b>	<b>2000</b>
<b>(iii) Economic Subsidy</b>	<b>500</b>
<b>(iv) Net factor income from abroad</b>	<b>1000</b>

**Ans.**  $GNP_{MP} = NDP_{FC} + NFIA + NIT$   
 $= 1800 + 1000 + 2000 - 500$   
 $= \text{Rs. } 20500$

**Q.20 Explain the functions of Commercial Banks.**

**[4]**

**Ans.** Functions of commercial bank can be divided into three parts

- (1) Primary Functions
- (2) Secondary Functions, and
- (3) Social Functions

**Accepting Deposits** - A bank accepts deposits from the public. People can deposit their cash balances in either of the following accounts to their convenience:

- (i) Fixed or Time Deposit Account
- (ii) Current or demand Deposit Account

- (iii) Saving deposit Account
- (iv) Home Safe Saving Account
- (v) Recurring Deposit Account

**Advancing Loans** - Another primary function of the commercial banks is to advance loans. A certain part of the cash received by the banks as deposits is kept in the reserve and the rest is given as loan. Banks advance loans mostly for productive purposes, on approved security. The amount of loan is generally less than the value of the security.

### **Secondary Function**

Besides the above primary functions, banks also perform many secondary functions viz. agency functions and general utility services.

- (i) collection and Payment of Various Items : Banks collect cheques, rent, interest, etc. on behalf of their customers and also make payment of taxes, insurance premium, etc., on their behalf.
- (ii) Purchase and Sale of Securities : Banks normally are more knowledgeable with regard to stock and share business. As such they buy, sell and keep in safe custody the securities on behalf of their customers.
- (iii) Trustee and Executor : Banks also act as trustees and executors of the property of their customers on their advice.

### **General Utility Services**

- (i) Locker Facilities : Banks provide locker facilities to their customers. People can keep their valuables or important documents in these lockers. Their annual rent is very nominal.
- (ii) Traveller's Cheque and Letters of Credit : Banks issue traveller's cheque and letters of credit to their customers so as to avoid their risk of carrying cash during journey.

**Q.21 Explain the main objectives of Budget. [4]**

**Ans.** Budget is a statement of expected annual receipts and expenditures of the government in the coming financial year i.e., April 1 to March 31. It also includes government report on its financial achievements and shortfalls over the past one year.

Objectives of Budget

Budget is not a mere statistical statement showing expected receipts and expenditures of the government. It is a detailed account of government's policies and objectives.

Main objectives of the budget are as follows:

**(1) Redistribution of Income and Wealth :** Government budget offers comprehensive information about its policies regarding taxation and subsidies. The government uses fiscal instruments of taxation and subsidies with a view to improving the distribution of income and wealth in the economy. Equitable distribution of income and wealth is a sign of social justice which is the principal objective of any welfare state as in India.

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**(2) Reallocation of Resources :** Private enterprises will always desire to allocate resources to those areas of production where profits are high. However, it is possible that such areas of production (like production of alcohol) may not promote social welfare. Through its budgetary policy, the government of a country directs the allocation of resources in a manner such that there is a balance between the goals of profit maximisation and social welfare. Production of goods which are injurious to health (like Cigaretter and Whisky) is discouraged through heavy taxation. On the other hand, production of 'socially useful goods' (like, 'Khadi') is encouraged through subsidies.

**(3) Economic Stability :** Free play of market forces (or the forces of supply and demand) are bound to generate trade cycles, also called business cycles from time to time. These refer to the phases of recession, depression, recovery and boom in the economy. The government of a county is always committed to save the economy from business cycles. Budget is used as an important polcy instrument to resist the situations of deflation and inflation. By doing it, the government tries to achieve the state of economic stability. Economic stability stimulates the inducement to invest and increases the rate of growth and development.

**(4) Managing Public Enterprises:** The budgetary policy of the government shows interest of the government to increase the rate of growth through public enterprises. Often, public sector enterprises are encouraged in areas of natural monopolies.

**Q.22 Explain the 'Expenditure Method' to measure the National Income. [5]**

**Ans.** Expenditure method is the third method of measuring national income. This is also called income Disposal method' or 'Consumption and Investment Method'.

**Definition**

Expenditure Method is the method which measures final expenditure on gross domestic product at market price during an accounting year. The total final expenditure is equal to the gross domestic product at market price.

Step involved in Expenditure Method

Estimating national income using expenditure method involves the following steps :

**(1) Step I : Identification of units incurring Final Expenditure**

All the economic units which incur final expenditure in the domestic territory of a country are broadly classified into the following groups.

- (1) Household Sector
- (2) Producer Sector
- (3) Government Sector
- (4) Rest of the World Sector

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### **(2) Step II :Classification of Final Expenditure**

In the context of measurement of national income using expenditure method, final expenditure is to be treated as the sum total of expenditure on the goods and services produced within the domestic territory of a country within one year. The value of this total should be equal to the value of gross domestic product at market price.

### **(3) Step III : Measurement of Final Expenditure**

The third step involves the measurement of the components of final expenditure. We require two types of data for this purpose

- (i) total volume of sale in the market
- (ii) retail prices.

### **Precautions Regarding Expenditure Method**

The following precautions are to be taken while using expenditure method:

- (1) Final Expenditure is to be taken into account to avoid error of double counting. Final expenditure is to be interpreted as expenditure on final goods and services. Intermediate goods and services (or expenditure on intermediate goods and services) refers to intermediate consumption, the value of which is already included in the value of final goods.
- (2) The intermediate expenditure is not included in the calculation of national income. Because the value of intermediate expenditure is already included in the value of final expenditure.
- (3) Expenditure on second hand goods is not included. Because, value of second hand goods has already been accounted during the year of their production.
- (4) Expenditure on shares and bonds is not included in total expenditure, as these are mere paper claims and are not related to the flow of final goods and services. Such expenditures do not cause any value addition.
- (5) Expenditure on transfer payments by the government is not included in total expenditure, e.g., old age pension, scholarship, etc. Because transfer payment do not cause any value addition in the economy.

**Q.23 Explain the determination of equilibrium level of Output, Income and Employment with the help of saving and Investment Curves. [5]**

**Ans.** In the Keynesian framework, the equilibrium between income - employment is also struck when saving and investment are equal.

It is very essential to note that saving and investment in the context of equilibrium refer to planned saving and planned investment (ex - ante saving and ex - ante investment). These are not actual saving and actual investment (ex - post saving and ex - post investment).

**Determination of income and Employment Equilibrium : Saving - Investment Approach**

Equilibrium level of income (employment) in terms of equality between saving (S) and investment (I) is illustrated in Table and Fig.

Income (Y)	Consumption (C)	Saving (Y - C)	Investment (I)
0	10	-10	10
10	15	-5	10
20	20	0	10
30	25	5	10
<b>40</b>	<b>30</b>	<b>-10</b>	<b>10</b>
50	35	15	10
60	40	20	10

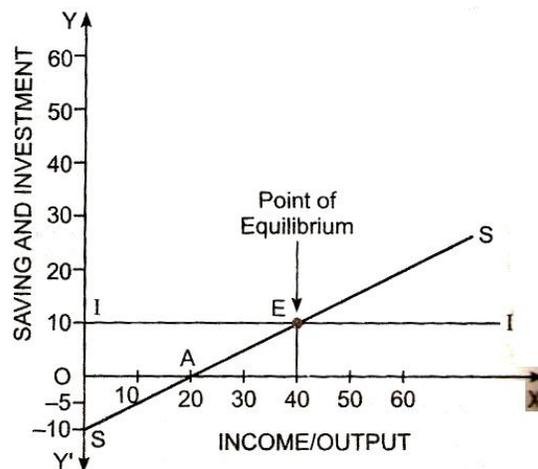


Table shows that equilibrium level of income (40) will be struck when saving and investment are equal, i.e., In other words, equilibrium will be struck when  $S = I = 10$ .

Equilibrium level of Income = 40

Fig. illustrates the occurrence of equilibrium in terms of saving and investment equality.

In Fig. income / output is shown on OX - axis and saving and investment on Y - axis. II is investment curve and SS is saving curve. II investment curve is an horizontal line, because it shows autonomous investment. SS curve starts from below the point of origin 'O'. It means that from point O to S, saving is negative and point A shows zero saving. Thereafter, saving becomes positive. Point E is an equilibrium point, because at this point investment curve II intersects, saving curve SS.

Equilibrium point E indicates that equilibrium of income will be struck at Rs. 40 crore.

If ex - ante S and ex - ante I are not equal to each other, i.e., when saving exceeds investment or is less than investment, the economy will not be in equilibrium. In other words, there will be no equilibrium in the economy. However, a free market economy, in such a situation, will undergo change such a change as to re - establish equality between the two.

**Q.24 Define money. Explain its main functions.**

**[5]**

**Ans. Meaning -** Money was introduced into the economy as a medium of exchange. Accordingly, anything that serves as a medium of exchange becomes eligible to be called money. With the passage of time, people

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started making saving in terms of money. In this way, money as a store of value also came to be associated with its meaning and definition. Besides, money was recognised as a measure of value.

Definition In the words of Crowther, "Money can be anything that is generally accepted as a means of exchange and at the same time acts as a measure and as a store of value.

### **Functions of Money**

Prof. Kinley has classified the functions of money into three categories

- (1) Primary or Main Functions
- (2) Secondary or Subsidiary Functions and
- (3) Contingent Functions

#### **(1) Primary or Main Functions**

This category includes those functions of money, which are common to all countries and in all periods. It includes the following two functions:

**(i) Medium of Exchange :** Medium of exchange is an important functions of money. It means that money acts as an intermediary that can be used in exchange for goods and services in an exchange transaction. As medium of exchange money has removed the main difficulty of barter system viz., lack of double coincidence of wants.

**(ii) Measure of Value of Unit of Value :** Measure of value is the other function of money. Money serves as a measure of value in terms of unit of account. Unit of account means that the value of each good or service is measured in the monetary unit. Measurement of value was the main difficulty of the barter system. Introduction of money has removed this difficulty.

#### **(2) Secondary or Subsidiary Functions**

This category includes those functions of money which are supplementary to the primary functions discussed above. Following three functions are notable in this regard.

**(i) Standard of Deferred Payments :** Deferred payments refer to those payments which are made sometime in the future Payment of loans also refers to the deferred payments.

**(ii) Store of Value :** Money acts also as a store of value. Individuals try to save a part of their income for their future needs. This is called the store of value.

**(iii) Transfer of Value :** Money also serves as a convenient mode of the transfer of value. In the present world, human wants have multiplied. Goods are purchased from far - off places for the satisfaction of wants. Because of its general acceptability and the merit of liquidity, money can be easily transferred from one place to the other.

#### **(3) Contingent Functions**

These functions are as under.

**(i) Basis of Credit Creation:** Prior to the introduction of money, creation of credit was not possible. Presently, in almost all countries of the world, instruments of credit like cheques, drafts, bills of exchange, etc. , are being used. Basis of these instruments of credit is money. Out of their income people deposit some money in banks. They can withdraw these deposits in terms of money by cheque. It is on the basis of these deposits that banks are in a position to create credit.

**(ii) Measurement of Maximum Satisfaction :** By spending wealth in terms of money a consumer can get maximum satisfaction and a producer maximum profit. A consumer can get maximum satisfaction from the consumption of different goods only when he equalizes marginal utilities of those goods. Study of such relationship has become possible only with money.

OR

**Write note on**

**(i) Planned - expenditure and non - plan expenditure.**

**Ans.**

Plan Expenditure	Non - plan Expenditure
It is within the scope of government plans.	It is out of scope of government plans.
It shows expenditure to be incurred on projects covered under the central plans.	It shows expenditure to be incurred on projects not covered under the central plans.
Examples : Expenditure on electricity generation, rural development, roads, bridges etc.	Examples : Expenditure on relief to the earthquake victims, construction of houses demolished due to floods etc.

**(ii) Private Income and Personal Income.**

**Ans.** The concept of private income is broader than the concept of personal income. The principal difference between private income and personal income is that while private income includes corporate taxes and corporate saving, personal income does not.