KENDRIYA VIDYALAYA SANGATHAN

ZIET MUMBAI

MINIMUM LEVEL OF LEARNING

FOR

CLASS XII

ECONOMICS

UNDER THE GUIDENCE

OF

DEPUTY COMMISSIONER

&

DIRECTOR

ZIET MUMBAI

Ms. USHA ASWATH IYER

COMPILED & PREPARED

BY

Mrs. PUSHPA VERMA

PGT – ECONOMICS

ZIET MUMBAI

Over 2 decades of teaching Economics for classes XI & XII , I have observed that Economics is not just a fascinating & interesting subject but also a little difficult for some students.

Under the guidance of Deputy Commissioner & Director ZIET Mumbai, Ms. Usha Aswath Iyer, I have taken up the project of compiling & preparing Minimum level of learning (MLL) in Economics for the students of Class XII , which should enable that the students who study this should be able to score at least 45 to 50% marks in the AISSCE Examination .

Please send your Suggestions for improvement to zietmumbai@gmail.com

Note to the Teachers

Dear Teachers,

Economics, the wonderful subject, yet often found tough by our students. Over the years, what has been noticed is that the efforts put in by the Teachers as well as the students; do not seem to produce the desired results in the AISSCE.

After putting in a lot of thought and I felt the need to prepare material in Economics for the students of Class XII, such that they are able to attain the Minimum level of Learning (MLL). This could be possible with the continued support and guidance from the Director ZIET Mumbai, Ms. Usha Aswath Iyer

This is my maiden attempt at the same.

I shall be grateful, if you could kindly spare your valuable time and go through the same critically. Please do send me a feedback which will be of great help in improving the same and giving it to our valuable students at the earliest for the forthcoming Board exams.

Look forward to your suggestions and feedback as soon as possible.

Mrs. Pushpa Verma

PGT Economics

ZIET Mumbai

How to use this study material?

Dear children,

This study material contains gist of the topics / units along with the assignments for self-assessment. Here are some tips to use this study material while revision during pre-boards and finally in board examination.

* Go through the syllabus given in the beginning. Identify the units carrying more weightage
* Suggestive blue print and design of question paper is a guideline for you to have clear picture about the form of question paper.
* Revise each of the topics / units and attempt the questions given for self-assessment.
* After attempting the self-assessment part, consult the question bank where questions carrying one, three/ four, six marks are given. Revise them
* After revision of all the units, solve the sample paper, and do self-assessment with the value points.
* Must study the marking scheme/solution for CBSE previous year paper which will enable you to know the coverage of content under different questions.
* Underline or highlight key ideas to have bird's eye view of all the units at the time of examination.
* Write down your own notes and make summaries with the help of this study material.
* Turn the theoretical information into outline mind maps.
* Make a separate revision note book for diagrams and numerical as well
* Discuss your **'DOUBTS'** with your teacher / other students.

Tips for students
Suggested sequence in which students may REVISE topics
When revising keep marking topics learnt
1.Explanation of features of various markets, Unit 4 2.Functions of Central bank, Unit7 3.Credit control by Central bank (CRR, SLR, Bank Rate, Open Market Operations) , Unit7 4.Components of Budget, Unit9 5.Fiscal Deficit & its implications, Unit9 6.Components of BOP, Unit 9 7. Phases showing relation between TP, AP, MP. , Unit3 8.Factors effecting Demand, Unit2 9. Change in demand & change in quantity demanded, Unit2 10.Factors effecting Supply, Unit3 11.Market equilibrium, Shifts in Demand & Supply & effect on equilibrium, Unit4 12.Consumer equilibrium, Unit2 13.Functions of money, Unit7 14.Producer equilibrium, Unit3 15.Sums on elasticity of Demand or supply, Unit2 &3 16.Deflationary & inflationary gap, Unit8 17.Sums from unit on determination of income, Unit8 18.Precautions in calculation of national income, Unit6

NOTE: - Students may feel free to give valuable suggestion on the mail pushpa.verma.62@ gmail.com to improve the quality of the study material.

EXAM. ORIENTED QUESTIONS WITH ANSWERS

UNIT 1: INTRODUCTION

ONE MARK QUESTIONS

Q1. What is economics about?

Ans: - Economics is the study of the problem of choice arising out of scarcity of resources having alternative uses.

Q2. Define scarcity.

Ans: - Shortage of resources in relation to their demand is called scarcity.

Q3. What is an economy?

Ans: - An economy is a system by which people get their living.

Q4. Define central problem.

Ans: - Central problem is concerned with the problems of choice (or) the problem of allocation of resources.

Q5. Give one reason which gives rise to economic problems?

Ans: - Scarcity of resources which have alternative uses.

Q6. Name the three central problems of an economy.

Ans: -
i) What to produce?
ii) How to produce?
iii) For whom to produce?

Q7. What is opportunity cost?

Ans: - It is the cost of next best alternative foregone.

Q8. Why is there a need for economizing of resources?

Ans: - Resources are scarce in comparison to their demand; therefore it is necessary to use resources in the best possible manner without wasting it.

Q9. What is production possibility frontier?

Ans: - It is a boundary line which shows the various combinations of two goods which can be produced with the help of given resources and technology.

Q10. Why PPC is concave to the origin?

Ans: - PPC is concave to the origin due to increasing marginal opportunity cost.

Q11. Define marginal rate of transformation.

Ans: - MRT is the ratio of units of one good sacrificed to produce one more unit of other goods.

$$MRT = \Delta y / \Delta x$$

Q12. Give two examples each of micro economics & macroeconomics.

Ans: - Microeconomics – Individual demand, individual supply

Macroeconomics – Aggregate demand and aggregate supply

3- 4 MARKS QUESTIONS

Q1. Distinguish between a centrally planned economy and a market economy.

SNo	Planned Economy	Market Economy
1	All the materials means of production are owned by government.	All the materials means of production are owned by private individuals.
2	Main objectives of production is social welfare	Main objectives of production are maximization of profit.
3	Ownership of property is under government control.	There is no limit to private ownership of property.
4	All the economic problems are solved as per direction of the planning commission.	All the economic problems are solved through price mechanism i.e., demand and supply.

Q2. Distinguish between micro economics and macroeconomics.

SNo	Micro economics	Macro economics
1	It studies individual economic unit.	It studies aggregate economic unit
2	It deals with determination of price and output in individual markets	It deals with determination of general price level and output in the economy.
3	Its central problems are price determination and allocation of resources.	Its central problem is determination of level of Income and employment in the economy.

Q3. Why is a production possibilities curve concave? Explain.

Ans. The production possibility curve being concave means that MRT increases as we move downward along the curve. MRT increases because it is assumed that no resource is equally efficient in production of all goods. As resources are transferred from one good to another, less & less efficient resources have to be employed. This raises cost and raises MRT.

Q4. Explain properties of a production possibilities curve.

Ans. There are two properties of a production possibilities curve.

1 Downward sloping: It is because as more quantity of one good is produced some quantity of the other good must be sacrificed.
2. Concave to the origin: It is because the marginal rate of transformation increases as more of one good is produced.

Q5. Explain the problem of .what to produce.

Ans. An economy can produce different possible combinations of goods & services with given resources. The problem is that, out of these different combinations, which combination is produced if production of one good increase then fewer resources will be available for other goods.

Q6. What is .Marginal Rate of transformation? Explain with the help of an example.

Ans. MRT is the rate at which the units of one good have to be sacrificed to produce one more unit of the other good in a two goods economy.

Suppose an economy produces only two goods X and Y. Further suppose that by employing these resources fully and efficiently, the economy produces 1X + 10Y. If the economy decides to produce 2X, it has to cut down production of Y by 2 units. Then 2Y is the opportunity cost of producing 1X. Then 2Y:1X is the MRT.

Q7. Explain the problem .How to produce..
Ans. Broadly, there are two techniques of production.

(i) Labour intensive Technique: Under this technique, production depends more on the use of labour.

(ii) Capital Intensive Technique: Under this technique, production depends more on the use of machines (called capital) efficient technique of production is that which uses minimum possible inputs for a given amount of output. So that, cost per unit of output is minimised.

Q8. Calculate the marginal opportunity cost (MOC) of commodity X for the given combination:

Commodity X	**0**	**1**	**2**	**3**	**4**	**5**
Commodity Y	**100**	**95**	**85**	**70**	**50**	**25**

Ans.

Commodity X	**Commodity Y**	**∆Y/∆X (Sacrificed/ Gain)**	**MOC**
0	**100**	**—**	**—**
1	**95**	**5/1**	**5**
2	**85**	**10/1**	**10**
3	**70**	**15/1**	**15**
4	**50**	**20/1**	**20**
5	**25**	**25/1**	**25**

Value based question

Q1. India is a labour abundance and capital scarce economy? Which technique of production should be used to produce the commodity?

Ans: - Labour Intensive Technique should be used to promote employment in India

Q2. As water resources are limited in our country, how can we economize the water resources so that it would not become a future problem for us? Give any two suggestions

Ans: - We can economize the water resources by:

1. **By preventing the water from being polluted and promoting new techniques which reduces the water pollution.**
2. **By rain water harvesting**

Q3. A teacher is getting Rs. 6000 per month as annual salary. If he leaves the job and starts tuition work he is expected to earn Rs. 5000. What would be his opportunity cost?

Ans: - Rs. 5000 is the opportunity cost for teacher working as a tutor.

Q4. A doctor has a private clinic in New Delhi and his actual earning is Rs. 10 lakh. If he starts working in New Delhi his annual salary will be Rs. 8 lakh. What is his opportunity cost for working in clinic in New Delhi?

Ans: - 8 lakh is next best alternative if he starts working in a clinic in New Delhi.

Q5. Indian economy is not utilizing its available resources to the maximum possible extent. As a result, its PPC is placed at lower level compared to the potential level. What needs to be done in this period?

Answer- (a) Economy has to identify the forces that prevent it from utilizing the resources fully and efficiently.
(b) In most production areas especially in rural areas, techniques of production need to be upgraded.

Q6. Production in an economy is below its potential due to unemployment. Government starts employment generation schemes. Explain its effect on PPC.

Answer- Since economy is producing below the PPC, for example at point K in the following
Diagram:
When government undertakes some employment generation schemes, the economy moves up
to reach the potential. The upward movement will be towards its PP curve. If unemployment
is fully removed .then the economy would starts operating on its PP curve.

Q7. A farmer is getting more profit in producing opium than in production of wheat. In the situation of famine which crop should be produced?
Ans- Production of Wheat because in the situation of famine, food- grain like wheat is required more than opium

Value- Social Welfare
Q8. There are various sources of income a teacher has such as
1. He can earn Rs 40000 from teaching in school.
2. He can earn Rs 50000 by tuition/coaching
3. He earns Rs 60000 by writing help book guides.
What is the opportunity cost of teaching in school? Why should he choose teaching profession?

Ans -Opportunity cost of teaching is writing books. He should choose teaching profession because it provides maximum social welfare
Value- Social Welfare

Q 9. What efforts should be made in an economy for the continuous use of exhaustible natural resources in production?

Ans – There are the various efforts-
1. To increase use of renewable resources
2. To explore the substitutes of resources
3. To reduce the wastage of resources.
4. To spread awareness about the effectively and optimum use of natural resources.
Value -Environmental Conservation

HOTS

Q1. What do you mean by economic problem?

Ans. Economic Problem refers to the problem of choice arising from the use of limited means to the satisfaction of various ends.

Example: Suppose a doctor having a private clinical in Delhi is earning Rs. 5lakhs annually. There are two other alternatives for him.

1) Joining a Govt. hospital in Bangalore earning Rs. 4 lakhs annually.

2) Opening a clinic in his home town in Mysore and earning 3 lakhs annually.

Q2. Find out opportunity cost. What is the shape of PPC?

Ans. The opportunity cost will be joining Govt. hospital in Bangalore. Increasing marginal opportunity cost implies that PPC is concave.

Q3. Although water is useful: yet it cheap. On the contrary diamond is not much of use, still it is very expensive. Give an economic reason for this paradox.

Ans. The economic reason for this paradox is scarcity. Although water is useful yet it is cheap due to its abundance in the economy. Diamonds are very expensive because they are scarce and people are ready to pay a high price.

Q4. "Only scarce goods attract price: "Comment.

Ans: The given statement is correct. All resources are not scarce in an economy. For example the

we breathe is abundant in nature in relation to our demand. Such goods are available free of cost and does not command price are known as non economic goods. Only goods which are scarce command price are called economic good.

Q5.What does the slope of PPF indicate?

Ans: PPF is downward sloping concave shaped curve.

Its downward slope indicates that more of one good can be produced only by taking resources away from the production of another good.

Q6. “Scarcity and choice go together “.Comment.

Ans: We live in a world of scarcity. All of us want better food, clothing, housing etc. But resources are not enough to meet our wants. Even the richest economy like USA is not able to fulfil all its demand of the resident. So we have to make choice among various scarce resources according to our priorities. Hence economics is concerned with the problem of choice under the conditions of scarcity.

Q7.A lot of people died and many factories were destroyed in an earthquake. How will it affect the PPF of the economy?

Ans: PPF of the economy will shift to the left. It happens because the number of possible combinations available with the economy has decreased, du to destruction of resources in the economy.

Q8. Massive unemployment will shift the PPF to the left. Defend or refute.

Ans: The given statement is refuted. Massive unemployment does not decrease the capacity of an economy to produce. So there will be no shift of PPF. However, economy will operate at some points some point inside the PPF due to underutilization of the resources.

Q9. What is Mixed Economy?

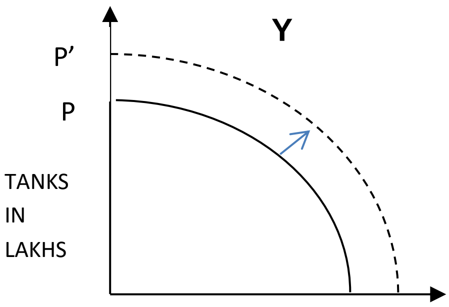
Ans. Today most societies are mixed economies. Most decisions are taken in the market but government plays an important role in overseeing the functioning, passes laws, that regulates the economies life, produce educational and police services and control pollution, etc. so most societies today operate as mixed economy.

Q10. Mention the reasons for the Shift in PP curve.

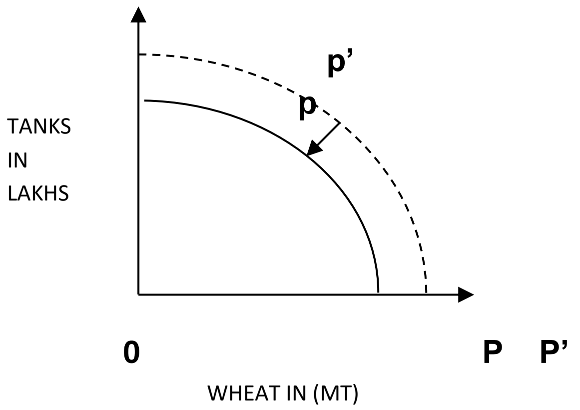
Ans. (1) Upward shift

(a) When there is improvement in technology.

(b) Increase in resources.



(2) Down ward shift :-- When Resources l WHEAT IN (MT) P P'



Q11. How are fundamental problems solved in the capitalistic economy?

Ans. In a market-oriented or capitalist economy, these fundamental problems are solved by the market. There is a price, which is influenced by the market forces of demand and supply. These forces guide which goods and how much is to be produced and consumed.

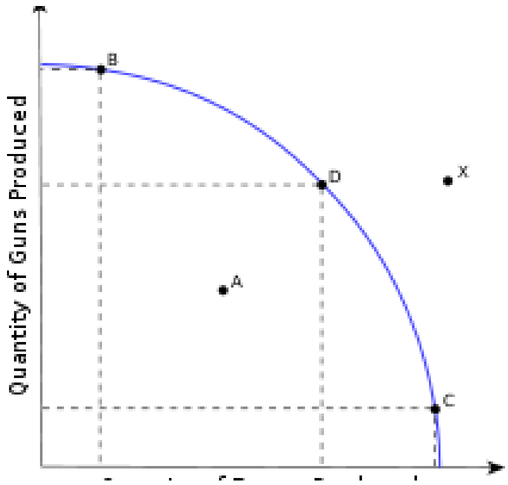
Q12. How are fundamental problems solved in the planned economy?

Ans. In a planned economy all the economic decisions regarding what, how and for whom to produce are solved by the state through planning. Economic planning replaces the price mechanism. The market is regulated and regulated by the state. The prices of the various products are fixed by the state called administered prices.

Q13. Indian economy is not utilizing its available resources to the maximum possible extent. As a result, its PPC is placed at lower level compared to the potential level. What needs to be done in this period?
Answer-(a) Economy has to identify the forces that prevent it from utilizing the resources fully and efficiently.
(b) In most production areas especially in rural areas, techniques of production need to be upgraded..

Q14 . Production in an economy is below its potential due to unemployment. Government starts employment generation schemes. Explain its effect on PPC.

Answer- Since economy is producing below the PPC, for example at point A in the following diagram.



When government undertakes some employment generation schemes, the economy moves up
to reach the potential. The upward movement will be towards its PP curve. If unemployment
is fully removed .then the economy would starts operating on its PP curve.

Q15. A farmer is getting more profit in producing opium than in production of wheat. In the situation of famine which crop should be produced?

Ans- Production of Wheat because in the situation of famine, food grain likes wheat is required more than opium

Value- Social Welfare

Q16. What is the opportunity cost of teaching in school? Why should he choose teaching profession?

Ans -Opportunity cost of teaching is writing books. He should choose teaching profession because it provides maximum social welfare

Value- Social Welfare

Q17. What efforts should be made in an economy for the continuous use of exhaustible natural resources in production?

Ans – There are the various efforts-

1. To increase use of renewable resources
2. To explore the substitutes of resources
3. To reduce the wastage of resources.
4. To spread awareness about the effectively and optimum use of natural resources.

Value -Environmental Conservation

EXAM ORIENTED QUESTIONS WITH ANSWERS

UNIT 2 CONSUMER BEHAVIOUR AND DEMAND

ONE MARK QUESTIOS:

Q1. What do you mean by utility?

Ans**: -** Utility is the want satisfying power of a commodity.

Q2.How is total utility derived from marginal utility?

Ans: - Total utility is the **sum total of marginal utilities** of various units of a commodity.

$TU_n = MU1+MU2+MU3\text{------} + MU_n$

Q3. State the law of equi-marginal utility.

Ans:- It states that a consumer gets maximum satisfaction when the ratio of the marginal utilities of two goods and their prices is equal i.e., $MU_x / P_x = MU_y / P_y$

Q4. What will you say about MU when TU is maximum?

Ans: - MU is zero when TU is maximum

Q5. What do you mean by indifference curve?

Ans. **Indifference curve refers to the graphical representation of various alternative combination of goods which provide the same level of satisfaction to the consumer.**

Q6. What do you mean by indifference map?

Ans: - indifference map refers to a set of indifference curve representing various levels of satisfaction of a consumer.

Q7. Define budget line.

Ans. Budget line is a graphical representation of all possible combination of two goods which can be purchased with given income and prices such that the cost of each of these combinations is equal to the money income of consumer.

Q8. Why the budget line is downward sloping?

Ans. The budget line is downward sloping as more of one good can be bought by decreasing some units of other goods with the given income.

Q9. Give the reason behind a convex indifference curve.

Ans: - Diminishing marginal rate of substitution.

Q10. What do you mean by substitute and complementary goods? Give two examples each.

Ans: - Substitute **goods** are those goods which can be used in place of each other. Ex: Tea and Coffee.

Complementary goods are those goods which are used together to satisfy a given want. Ex: Car and petrol.

Q11. What is demand function?
Ans: -The functional relationship between the quantity demanded and the factors of demand is called demand function.

Q12. Define price elasticity of demand.
Ans: - It refers to the degree of responsiveness of quantity demanded to change in price.

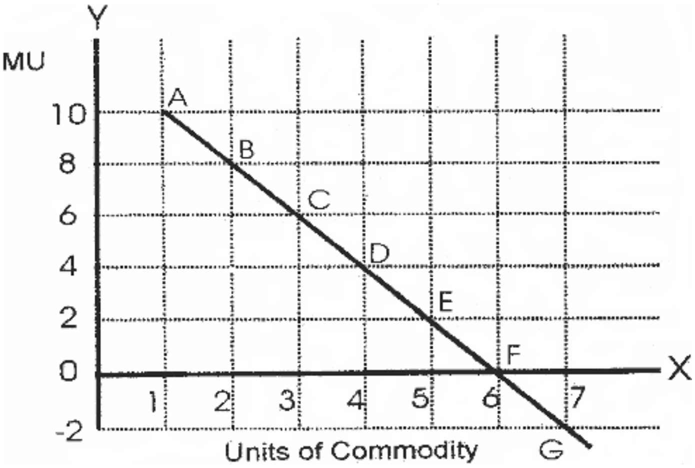
Q13. What is meant by consumer's equilibrium?

Meaning: A consumer is to be equilibrium when he is spending his given income on various goods and services to get maximum satisfaction.

3 - 4 MARKS QUESTIONS

Q1. Explain the law of Diminishing Marginal Utility with the help of a table.
Ans: - The law of diminishing Marginal Utility states that as we consume more and more units of a commodity, the MU derived from the successive units of that commodity goes on decreasing. It is explained with the help of following schedule and diagram.

UNITS	TU	MU
1	10	10
2	18	8
3	24	6
4	28	4
5	30	2
6	30	0
7	28	-2



Q2. What is the difference between cardinal and ordinal utility analysis.

	Cardinal Utility	Ordinal Utility
1	Given by Prof. Alfred Marshall	Given by Prof. J.R. Hicks
2	Utility can be measured numerically	It cannot be measured numerically
3	Unit of measurement is 'utils'	Possible for a consumer to scale his preferences.

Q3. Explain any four determinants of demand for a commodity.

Ans:- Following are the three determinants of demand for a commodity.

i) **Price of the commodity:-** When the price of a commodity increases the demand for that commodity decreases and vice versa.

ii) **Income of the consumer:-** When the income increases the demand for normal commodity also increases and vice-versa.

iii) Price of related goods :-

a) **In complementary goods** demand rises with fall in price of complementary goods.

b)In substitute goods demand for a commodity falls with a fall in the price of other substitute goods

b) Taste & preference of the consumer: With favourable taste, demand increase and unfavourable taste demand decreases for a commodity.

Q4. Explain any four factors that affect elasticity of demand.

Ans: - Following are the factors affecting price elasticity of demand.

1. **Availability of close substitutes**: If close substitutes of product are available, the commodity tends to be more elastic, If there are not available, they tend to be less elastic.
2. **Proportion of total expenditure spent on the product**:If the amount spent on a product constitutes a very small fraction of the total expenditure, then the demand tends to be less elastic of the amount spent is high the elasticity of demand tends to be high.

3. **Habits:** A commodity if it forms an essential part of the individual, the demand tends to be inelastic. It is consumed casually; the demand tends to be elastic
4. **Time period:** Longer the time period, the more elastic is the demand for any product the shorter the time period, less elastic is the demand for any products

Q5.Explain the factors affecting the market demand of a commodity.

Ans**: - i)** **Meaning**: Market demand is the aggregates of the quantities demanded by all the consumers in the market at different prices.

ii) Factors affecting market demand :

a) Price of the commodity: When the price goes up demand for its falls and vice-versa.
b) Income of the consumers*:* When the income of the consumers goes up the demand for a commodity also goes up.
c) Price of related goods :
   - Complementary goods: The demand for a commodity rises with a fall in the price of its complementary good (Car and petrol)
   - Substitute goods: Demand for a commodity falls with a fall in the price of other substitute good (Tea& Coffee).
d) Tastes and preferences: Any favourable change in consumers' tastes will lead to increase in market demand and any unfavourable change in consumers tastes will lead to decrease in market demand.
e) Consumer's group: More the consumers more will be market demand and vice-versa.

Q6. Explain the various degrees of price elasticity of demand with the help of diagrams.

Ans: - There are five degrees of price elasticity of demand. They are,

a) **Perfectly elastic demand (Ed=∞):-** a slight or no change in the price leads to infinite changes in the quantity demanded.

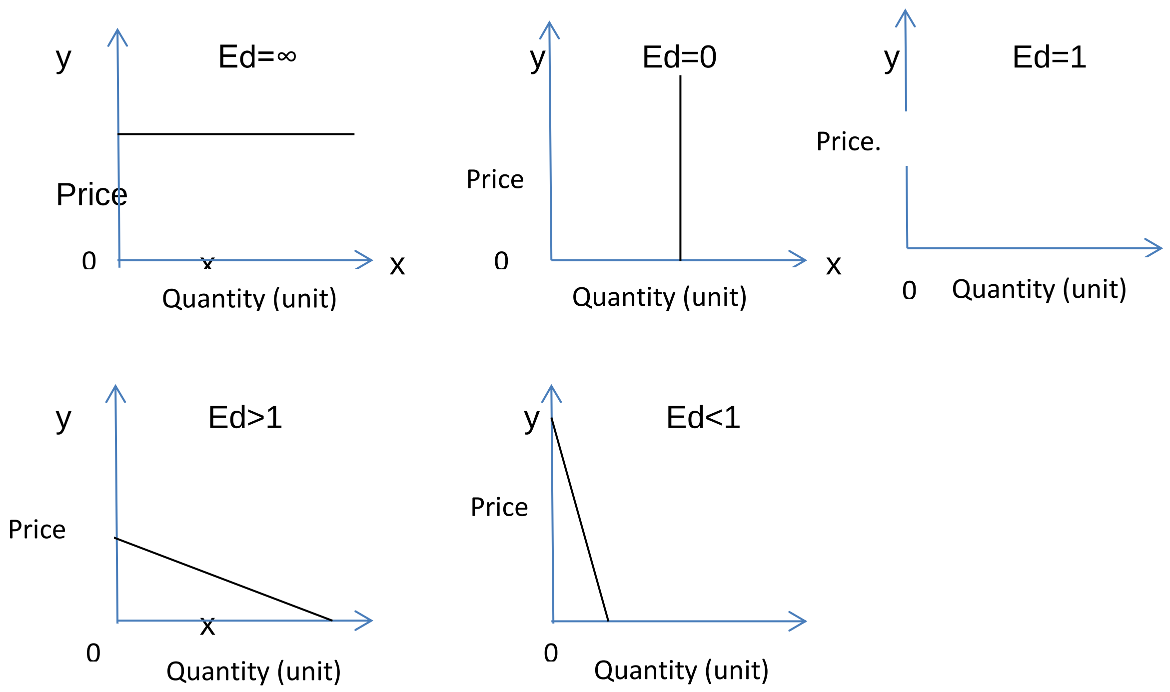
b) **Perfectly Inelastic demand (Ed=0)** *:-* Demand of a commodity does not change at all irrespective of any change in its price.

c) **Unitary elastic demand (Ed=1):-** When the percentage change in demand (%) of a commodity is equal to the percentage change in price.

d) **Greater than unitary elastic demand (Ed>1):-** When percentage change in demand of a commodity is more than the percentage change in its price.

e) **Less than unitary elastic demand (Ed<1)** *:-* When percentage change in demand of a commodity is less than the percentage change in its price.

Diagrams of different elasticity of demand:



Q7. Distinguish between change in quantity demanded and change in demand of a Commodity.

Basis	**change in quantity demanded**	**change in demand**
Meaning	when demand change due to change in price, keeping other factors constant, it is known as change in quantity demanded	when demand change due to change in factors other than own price of the commodity it is known as change in demand
Effect on demand curve	It leads to movement along the same demand curve.	It leads to shift in the demand curve
Reason	It occurs due to an increase or a decrease in It occurs due to an increase or a decrease in the price of the given commodity the price of the given commodity	It occurs due to change in other factors, like change in price of substitute goods, change in income of the consumer etc.

Q8. Distinguish between Expansion in demand and increase in demand of a commodity.

Basis	Expansion in demand	increase in demand
Meaning	When the quantity demand rises due to fall in the price of the commodity, keeping other factors constant, it is known as Expansion in demand	• **Increase in demand refers to a rise in the demand of a commodity caused due to any factor other than the own price of the commodity.**
Tabular Presentation	Price(Rs) Demand(units 12. 100 10 150	Price(Rs) Demand(units) 12. 100 12 150
Effect on demand curve	There is downward movement along the same demand curve	**There is rightward shift of demand curve.**
Reason	**is occurs due to a decrease in the price of the given commodity**	**It is occurs due to favourable change in the other factor**, like increase in price of substitute goods, increase in income of the consumer etc.

Q9. Distinguish between contraction in demand and decrease in demand of a commodity.

Basis	Contraction in demand	Decrease in demand

Meaning	When the quantity demand falls due to rise in the price of the commodity, keeping other factors constant, it is known as in **Contraction in** demand	**Decrease in demand refers to a fall in the demand of a commodity caused due to any factor other than the own price of the commodity**
Tabular Presentation	Price(Rs) Demand(units) 10. 150 12 100	Price(Rs) Demand(units) 12. 150 12 100
Effect on demand curve	There is upward movement along the same demand curve.	**There is leftward shift of demand curve.**
Reason	**is occurs due to a increase in the price of the given commodity**	**It is occurs due to unfavourable change in the other factor** like decrease in price of substitute goods, decrease in income of the consumer etc.

Q10. Given price of a good, how does a consumer decide as to how much of that good to buy?

Ans. Consumer purchases up to the point where marginal utility of commodity is equal to the price of the commodity (Mux = P). So long as marginal utility is greater than price, he keeps on purchasing. As he makes purchases MU falls and at a particular quantity of the good MU becomes equal to price. Consumer purchases up to this point.

Q11. What happens when MU_X/P_X is Not Equal to $MU_Y/P_{Y?}$

(I) **Suppose, $MU_X/ P_X > MU_Y/P_Y$. In this case, the consumer is getting more marginal utility per rupee in case of good X as compared to Y. Therefore, he will buy more of X and less of Y. This will lead to fall in**

MU_X and rise in MU_Y. The consumer will continue to buy more of X till $MU_X/P_X = MU_Y/P_Y$

(II) **When $MU_X/P_X < MU_Y/P_Y$, the consumer is getting more marginal utility per rupee in case of good Y as compared to X. Therefore, he will buy more of Y and less of X. This will lead fall in MU_Y and rise in MU_X. The consumer will continue to buy more of Y till $MU_X/P_X = MU_Y/P_Y$.**

It brings us to a conclusion that $MU_X/P_X = MU_Y/P_Y$ is a necessary condition to attain Consumer's Equilibrium.

Q12. Explain how the demand for a good is affected by the price of its related goods. Give examples.

Ans. Related goods are either substitutes or complementary
Substitutes Goods: When price of a substitute falls, it becomes cheaper than the given good. So the consumer substitutes it for given good will decrease. Similarly, a rise in the price of substitute will result in increase in the demand for given good.
For example: Tea and Coffee.

Complementary Goods: When the price of a complementary good falls its demand rises and the demand for the given good will increase. Similarly when price of complementary good increases, and then demand for given good decreases.
For example: .Car & Petrol.

.Q13. Distinguish between normal goods and inferior goods. Give example also.

Ans. Normal Goods: These are the goods the demand for which increases as income of the buyer rises. There is a positive relationship between income and demand or income effect is positive.
Example; Rice, Wheat

Inferior Goods: These are the goods the demand for which decreases as income of buyer rises. Thus, there is negative relationship between income and demand or income effect is negative.
Example: coarse grain, coarse cloth

Q14. Explain relationship between total utility and marginal utility with the help of a schedule
.
(1) When MU is positive, TU increases.
(2) When marginal utility is equal to zero then total utility will maximum.
(3)When marginal utility is negative; total utility starts diminishing

Unit consumed	Marginal utilit(MU)	Total utility(TU)
1	20	20
2	16	36
3	10	46
4	4	50
5	0	50
6	-6	44

Q15. Define marginal utility. State the law of diminishing marginal utility.

Ans; Marginal **Utility:** It is addition more to the total utility as consumption is increased by one more unit of the commodity.
Law of Diminishing Marginal utility: It states that as consumer consumes more and more units of a commodity, the utility derived from each successive unit goes on decreasing. According to this law TU increases at decreasing rate and MU decreases.

1. **Q16. Explain the law of demand with schedule and diagram**.

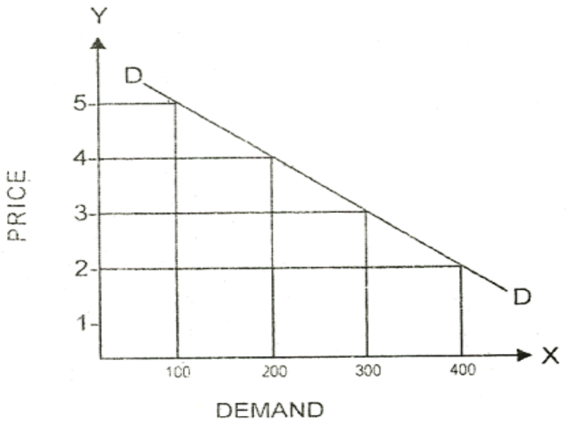
Ans: Definition: The **law of demand** states that other factors being constant price and quantity **demand** of any good and service are inversely related to each other when the price of a product increases, the **demand** for the same product will fall.

Assumptions of the law

1. There is no change in income of consumers.
2. There is no change in the price of product.
3. There is no change in quality of product.
4. There is no substitute of the commodity.
5. The prices of related commodities remain the same.
6. There is no change in taste and preference of consumers.
7. The size of population remains the same.
8. The climate and weather conditions are same.
9. The tax rates and other fiscal measures remain the same.

Price (in Rs.)	5	4	3	2	1
Quantity demanded (units)	100	200	300	400	500

Diagram



6 MARKS QUESTIONS

Q.1 Explain the three properties of indifference curves.

Ans. Three properties of indifference curves are as follow.

1. **Indifference curves slopes downward from left to right:** To consume more of one good the consumer must give up some quantity of the other good so that total utility remains the same.
2 **indifference curves are always convex to the origin:** MRS declines continuously due to the operation of the law of diminishing marginal utility.
3. **Higher indifference curves represent higher level of satisfaction:** Higher indifference curve represent large bundle of goods which means more utility because of monotonic preference.
4. **indifference curves can never intersect each other:** As two indifference curves cannot represent the same level of satisfaction, they can not intersect each other. It means indifference curve will pass through given point on an indifference map.

Q2. Explain Consumer's Equilibrium in case of Two Commodities:

Ans: There are two necessary conditions to attain Consumer's Equilibrium in case of Two Commodities:

(i) **Marginal Utility (MU) of last rupee spent on each commodity is same:**i. We know, a consumer in consumption of single commodity (say, x) is at equilibrium when $MU_x/P_x = MU_M$

(ii) (ii) Similarly, consumer consuming another commodity (say, y) will be at equilibrium when $MU_Y/P_Y = MU_M$

Equating 1 and 2, we get: $MU_X/P_X = MU_Y/P_Y = MU_M$

As marginal utility of money (MU_M) is assumed to be constant, the above equilibrium condition can be restated as: $MU_X = MU_Y/P_Y$ or $MU_X/MU_Y = P_X/P_Y$

(ii) MU falls as consumption increases:

The second condition needed to attain consumer's equilibrium is that MU of a commodity must fall as more of it is consumed. If MU does not fall as consumption increases, the consumer will end up buying only one good which is unrealistic and consumer will never reach the equilibrium position.

Finally, it can be concluded that a consumer in consumption of two commodities will be at equilibrium when he spends his limited income in such a way that the ratios of marginal utilities of two commodities and their respective prices are equal and MU falls as consumption increases.

Explanation with the help of an Example: Let us now discuss the law of equi-marginal utility with the help of a numerical example. Suppose, total money income of the consumer is Rs. 5, which he wishes to spend on two commodities: 'x' and 'y'. Both these commodities are priced at Rs. 1 per unit. So, consumer can buy maximum 5 units of 'x' or 5 units of 'y'. In Table 2.4, we have shown the marginal utility which the consumer derives from various units of 'x' and 'y'.

Table : Consumer's Equilibrium in case of Two Commodities

Unit	MUx	MUy
1	**20**	**16**
2	**14**	**12**
3	**12**	**8**
4	**7**	**5**

5	**5**	**3**

It is obvious that the consumer will spend the first rupee on commodity ‘x’, which will provide him utility of 20 utils. The second rupee will be spent on commodity ‘y’ to get utility of 16 utils. To reach the equilibrium, consumer should purchase that combination of both the goods, when: (i) MU of last rupee spent on each commodity is same; and (ii) MU falls as consumption increases. It happens when consumer buys 3 units of ‘x’ and 2 units of ‘y’ because: i. MU from last rupee (i.e. 5^{th} rupee) spent on commodity y gives the same satisfaction of 12 utils as given by last rupee (i.e. 4^{th} rupee) spent on commodity x; and ii. MU of each commodity falls as consumption increases. The total satisfaction of 74 utils will be obtained when consumer buys 3 units of ‘x’ and 2 units of ‘y’. It reflects the state of consumer’s equilibrium. If the consumer spends his income in any other order, total satisfaction will be less than 74 utils.

Q3. Explain the conditions of consumer’s equilibrium using indifference curve analysis. Use diagram.

Ans. Consumer equilibrium refers to a situation, in which a consumer derives maximum satisfaction, with no intention to change it and subject to given prices and his given income. The point of maximum satisfaction is achieved by studying indifference map and budget line together. On an indifference map, higher indifference curve represents a higher level of satisfaction than any lower indifference curve. So, a consumer always tries to remain at the highest possible indifference curve, subject to his budget constraint.

Conditions of Consumer's Equilibrium:

The consumer's equilibrium under the indifference curve theory must meet the following two conditions:

(i) **MRS_{XY} = Ratio of prices or P_X/P_Y**

(ii) Let the two goods be X and Y.

(iii) The first condition for consumer's equilibrium is that

$MRS_{XY} = P_X/P_Y$

a. If $MRS_{XY} > P_X/P_Y$, it means that the consumer is willing to pay more for X than the price prevailing in the market. As a result, the consumer buys more of X. As a result, MRS falls till it becomes equal to the ratio of prices and the equilibrium is established.

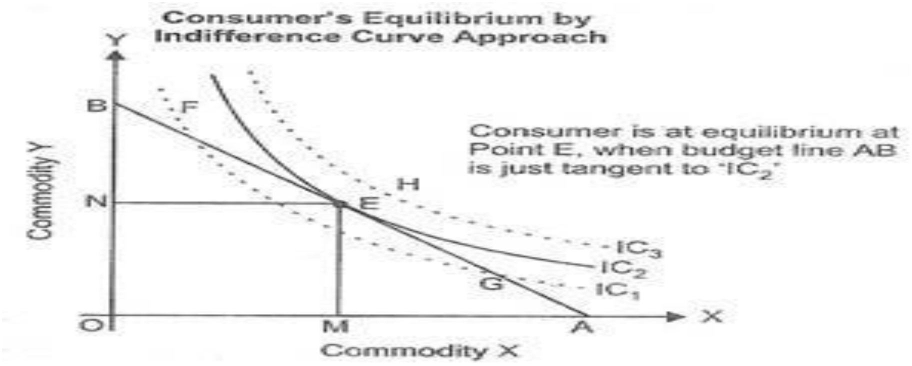
b. If $MRS_{XY} < P_X/P_Y$, it means that the consumer is willing to pay less for X than the price prevailing in the market. It induces the consumer to buys less of X and more of Y. As a result, MRS rises till it becomes equal to the ratio of prices and the equilibrium is established.

(ii) MRS continuously falls:

The second condition for consumer's equilibrium is that MRS must be diminishing at the point of equilibrium, i.e. the indifference curve must be convex to the origin at the point of equilibrium. Unless MRS continuously falls, the equilibrium cannot be established.

Thus, both the conditions need to be fulfilled for a consumer to be in equilibrium.

Let us now understand this with the help of a diagram:



In Fig. 2.12, IC_1, IC_2 and IC_3 are the three indifference curves and AB is the budget line. With the constraint of budget line, the highest indifference curve, which a consumer can reach, is IC_2. The budget line is tangent to indifference curve IC_2 at point 'E'. This is the point of consumer equilibrium, where the consumer purchases OM quantity of commodity 'X' and ON quantity of commodity 'Y.

All other points on the budget line to the left or right of point 'E' will lie on lower indifference curves and thus indicate a lower level of satisfaction. As budget line can be tangent to one and only one indifference curve, consumer maximizes his satisfaction at point E, when both the conditions of consumer's equilibrium are satisfied:

(i) MRS = Ratio of prices or P_X/P_Y:

At tangency point E, the absolute value of the slope of the indifference curve (MRS between X and Y) and that of the budget line (price ratio) are same. Equilibrium cannot be established at any other point as $MRS_{XY} > P_X/P_Y$ at all points to the left of point E and $MRS_{XY} < P_X/P_Y$ at all points to the right of point E. So, equilibrium is established at point E, when $MRS_{XY} = P_X/P_Y$.

(ii) MRS continuously falls:

The second condition is also satisfied at point E as MRS is diminishing at point E, i.e. IC_2 is convex to the origin at point E.

HOTS

Q1. Is the demand for the following elastic, moderate elastic, highly elastic? Give reasons.

(i) Demand for petrol
(ii) (ii)Demand for text books
(iii) (iii) Demand for cars
(iv) (iv) Demand for milk

Ans

(i) Demand for petrol is moderately elastic , because when the price of the petrol goes up , the consumer will the use of it.

(ii) Demand for text books is completely inelastic. In case of text books, even a substantial change in price leaves the demand unaffected.

(iii) Demand for cars is elastic. It is a luxury good, when the price of the car rises, the demand for the car comes down.

(iv) Demand for milk is elastic, because price of the milk increases then the consumer purchase less quantity milk.

Q2. State any three causes of decrease in demand? (Or) Mention any three causes for leftward shift in demand curve

a) Decrease in income of the consumer.
b) Fall in the price of substitute good
c) Rise in the price of complementary goods.

Numerical questions:

Q1. A person's total utility schedule is given below. Derive his marginal utility schedule

Amount consumed	0	1	2	3	4	5
Total Utility (Units)	0	10	25	38	48	55

Solution: -- MU: 10 15 13 10 7

Q2. A person's MU schedule is given below. Derive her TU schedule (Assume that TU of consuming zero unit is zero):

Amount consumed	**1**	**2**	**3**	**4**	**5**
Total Utility (Units)	**7**	**10**	**8**	**6**	**3**

Solution. TU : 7 17 25 31 34 34

Q.3 Complete the following table:

Amount consumed	1	2	3	4	5
Total Utility (Units)	50	90	-	140	150
Marginal Utility (Units)	50	-	30	-	-

Solution.

TU	50	90	120	140	150
MU	50	40	30	20	10

Q.4 The following is the utility schedule of a person:

Amount consumed	1	2	3	4	5
Marginal Utility (Units)	5	4	3	2	1

Ans. Suppose that the commodity is sold for Rs. 3. How many units of the commodity the person will purchase so that his TU maximum?

Solution. The consumer will purchase 3 units of the commodity such that

$MU_x = P_{x'}$ i.e., 3 = 3

Q5. Suppose the price of a commodity 'x' is given as Rs. 8 and the MU (in terms of money) for 4 units is given as:

Units	1	2	3	4
MU_x (Rs)	12	10	8	6

How many units should a consumer purchase so that his satisfaction is maximum?

Solution.

Units Consumed	MU_x (in Rs)	Price (P_x) (in Rs)
1	12	8
2	10	8
3	8	8
4	6	8

Consumer will purchase 3 units because at 3rd unit, MU = Price, 8= 8

DEMAND AND ELASTICITY OF DEMAND

Q.1 There are 3 households: A, B and C in a market. From the following tavle, calculate demand for household B at various levels of price:

Price (Rs)	Household A	Household B	Household C	Market Demand
14	12	-	22	52
12	16	-	32	72
10	24	-	44	102
8	34	-	60	142
6	48	-	84	198

Demand for Household B = Marker Demand – A's demand – C's demand

Q2. The following table shows the expenditure, which Amit is willing to spend on commodity 'X' at various levels of price. Prepare demand schedule of Amit.

Price (Rs)	5	6	7	8	9
Expenditure (Rs)	100	96	84	80	72

Solution.

Price (Rs)	Expenditure (Rs)	Demand in units (Expenditure ÷ Price)
5	100	100 ÷ 5 = 20
6	96	96 ÷ 6 = 16
7	84	84 ÷ 7 = 12
8	80	80 ÷ 8 = 10
9	72	72 ÷ 9 = 8

Q3. When price is Rs.10 per unit, demand for a commodity is 100 units. As the price falls to Rs8 per unit, demand expanded to 150 units. Calculate elasticity of demand.

$$\textbf{Ed} = \frac{P}{Q} \times \frac{\Delta Q}{\Delta P} = \frac{10}{100} \times \frac{50}{-2} = (-)\ 2.5$$

Q4. A consumer buys 80 units of a good at price of Rs. 5 per unit. suppose, the price elasticity of demand is (-). At what price will he buy 64 units?

$$\textbf{Ed} = \frac{P}{Q} \times \frac{\Delta Q}{\Delta P} \qquad -2 = \frac{-16}{\Delta p} \times \frac{5}{80} = \Delta p = 0.5$$

Q5. A 5% fall in the price of x leads to 10 % rise in the demand for x. a 20% rise in the price of y lead to 6% fall in demand for y. Calculate the price elasticity of demand of x and y. out of x and y, which commodity is more elastic?

Ans. Price elasticity of demand (Ed) of x commodity

$$\text{Price elasticity of demand (Ed)} = \frac{\text{Percentage change in quantity demanded}}{\text{Percentage change in price}}$$

$$= \frac{10\%}{-5\%} = (-)\ 2$$

Price elasticity of demand (Ed) of y commodity

Percentage change in quantity demanded
Price elasticity of demand (Ed) = ---
Percentage change in price

-6%
= -------------------------- = (-) 0.3
20%

Q6. When price of sugar is Rs 5 pr kg, its demand is 50 kg. When price rises by Rs 5 per kg, its demand falls by 10 kg. Calculate the elasticity of demand.

Original Quantity (Q) = 50kg	Original Price (P) = Rs 5
New Quantity (Q_1) = 40kg	New Price (P_1) = Rs 10
Change in Quantity (ΔQ) = -10kg	Change in Price (ΔP) = Rs 5
Elasticity of Demand (E_d) =?	

Price Elasticity of demand (E_d) = ΔQ/ΔP X P/Q = -10/5 X 5/50 = (-) 0.2

Answer. E_d = (-) 0.2 (Demand is less elastic as $E_d < 1$)

Negative sign of Ed indicates the inverse relationship between price and quantity demanded.

<u>Calculation of Elasticity of demand (When Elasticity of demand is given)</u>

Q7. The market demand for a good at Rs 4 per unit is 100 units. Due to increase in price, the market demand falls to 75 units. Find out the new price, if the price elasticity of demand is (-) 1.

Original Quantity (Q) = 100 units	Original Price (P) = Rs 4
New Quantity (Q_1) = 75 units	New Price (P_1) = ?
Change in Quantity (ΔQ) = -25 units	Change in Price (ΔP) = ΔP
Elasticity of Demand (E_d) = (-) 1	

Solution.

Price Elasticity of demand (E_d) = $\Delta Q/\Delta P$ X P/Q

-1 = -25/ΔP X 4/100 ΔP =Rs 1

As the quantity demanded is decreasing, price will increase. It means,

New Price = Original Price (P) + Change in Price (ΔP) = 4+1 = Rs 5

Answer. New Price = Rs 5

<u>**Calculation of Elasticity of Demand** (When Total Expenditure is given)</u>

Q8. Calculate price elasticity of demand:

Price (Rs)	Total Expenditure (Rs)
5	500
6	420

Solution.

Price (Rs)	Total Expenditure (Rs)	Quantity (in units) (Total Expenditure ÷ Price)
5	500	100
6	420	70

Original Quantity (Q) = 100 units	Original Price (P) = Rs 5
New Quantity (Q_1) = 70 units	New Price (P_1) = Rs 6
Change in Quantity (ΔQ)	Change in Price (ΔP) = Rs 1
Elasticity of Demand (E_d) = ?	

Price Elasticity of demand (E_d) = $\Delta Q/\Delta P$ X P/Q = - 30/1 X 5/100 = (-) 1.5

Answer. E_d = (-) 1.5 (Demand is highly elastic as E_d > 1)

Negative sign of E_d indicates the inverse relationship between price and quantity demanded.

UNIT 3 PRODUCER BEHAVIOUR AND SUPPLY

VERY SHORT ANSWER TYPE QUESTIONS(ONE MARK EACH)

Q1.What is a production function

Ans. Production function is the relationship between physical input and physical output.

Q2. Define total product?

Ans. It is sum total of output produced by all units of labour. TP=AP*L

Q3. Define marginal product?

Ans. Marginal product is the change in total product as a result of a unit change in the input of a variable factor. MP or MPP =TPn -TPn-1

Q4.When is total output maximum?

Ans. When MP Is zero.

Q5. Can TP and AP become zero or negative?

Ans. No, they can never be zero or negative.

Q6. Define the "Law of variable proportion"

Ans. Other things remaining constant, as the amount of variable factor is increased, the MP after a certain time starts falling.

SHORT ANSWER TYPE QUESTIONS (3&4 MARKS)

Q1. Explain the relationship between marginal product and total product?

Ans. (i) When MP increases, TP increases at increasing rate. (ii) When MP constant, TP increases at constant rate. (iii) When MP decreases, TP increases at diminishing rate.

Q2. Complete the following table:

Unit of labour	1	2	3	4	5	6	7
TP	40	80	110	130	140	140	130

AP - - - - - - -

MP

Unit of labour	TP	AP= TP/ Unit of labour	MP=TPn-TPn- 1
1	40	40	40
2	80	40	40
3	110	36.66	30
4	130	32.5	20
5	140	28	10
6	140	23.33	0
7	130	18.57	-10

Ans.

Q3. Identify different stages of production and state the related law?

Units of labour:	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**
Units of output:	**2**	**6**	**12**	**16**	**18**	**18**	**14**	**8**

Ans.

Units of labour:	Units of output:	MP	STAGE
1	2	-	Phase/stage I : increasing returns
2	6	4	
3	12	6	
4	16	4	Phase/stage II : diminishing returns
5	18	2	
6	18	0	
7	14	-4	Phase/stage III : negative returns

8	**8**	**-6**

Q4. What are the causes of increasing returns to a factor?

Ans. 1) Fuller utilization of the fixed factor: -- In the first phase, the supply of the fixed factor is too large, whereas variable factors are too few. So, the fixed factor is not fully utilised. When variable factors are increased and combined with fixed factor, than fixed factor is better utilised and output increases at an increased rate.

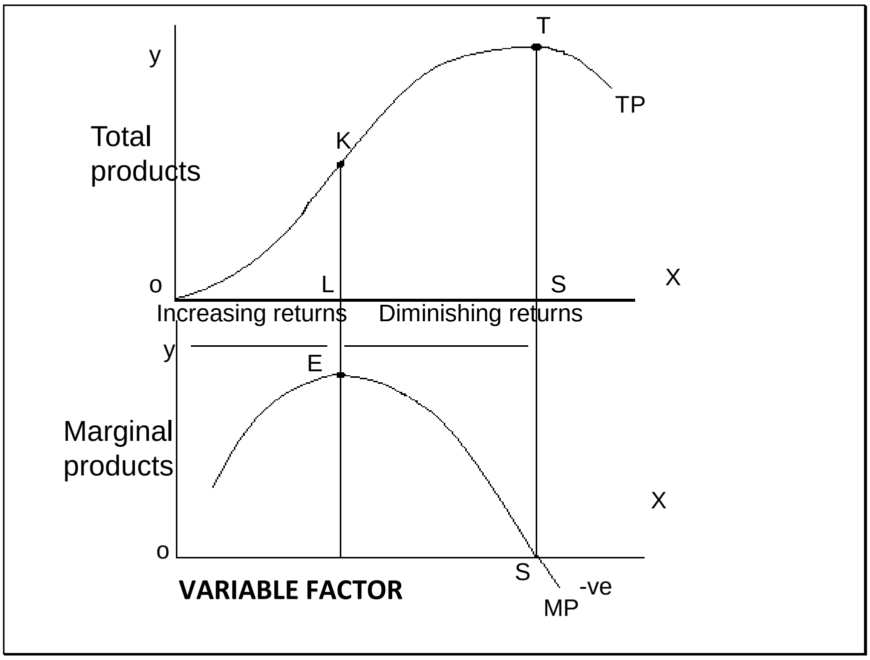
2)_Increased efficiency of the variable factor: - when the variable input is increased efficient utilization of the fixed factor take place due to specialization. This raises efficiency of the variable input.

Q5. Explain the law of variable proportion with the help of TP& MP curves.

OR

Explain the law of return to a factor with the help of TP & MP curves.

Ans. Law of variable proportion: -- It states that as more and more of the variable factor is combined with the fixed factor a stage will come when MP of variable factor starts declining.



Phase1 (between o to K): -- TP increases at an increasing rate and MP also increases.

Phase2 (between K to T): --TP increases at a decreasing rate and MP falls.

This phase ends when MP becomes zero and TP reaches its maximum point.

Phase 3(beyond point T): -- TP starts decreasing and MP not only falls, but also becomes negative.

CONCEPTS OF REVENUE

VERY SHORT ANSWER TYPE QUESTIONS (ONE MARK EACH)

Q1. What is meant by revenue?
Ans. Revenue refers to money receipts of a firm from the sale of its output.

Q2. Define total revenue?
Ans. Total revenue is the sum total of revenue derived from the sale of all units of the commodity.

$$TR = \sum MR$$

Q3. What is meant by average revenue?

Ans. Average revenue is the revenue per unit of output sold.

$$AR = TR/Q$$

Q4. Define marginal revenue?

Ans. Marginal revenue is the change in total revenue as a result of selling one more unit of output.

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

Q5. Which concept of revenue is called price?

Ans. Average revenue is called price.

SHORT ANSWER TYPE QUESTIONS (3&4 MARKS)

Q1. What changes should take place in total revenue so that (i) marginal revenue is positive and constant, and (ii) marginal revenue is falling?

Ans. (i) when MR is positive and constant, TR should increase at a constant rate
(ii) When MR is falling, TR should increase at a decreasing rate.

Q2. What change will take place in marginal revenue when:

- **(i) Total revenue increase at increasing rate?**
- **(ii) Total revenue increases at a diminishing rate?**
- **(iii) Total revenue increases at a constant rate?**

Ans.

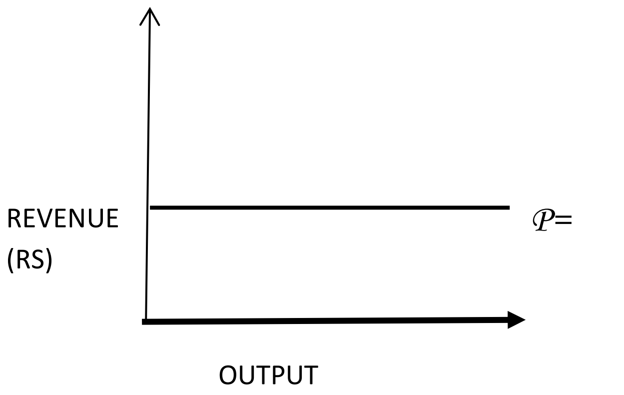
(i) When total revenue increases at an increases rate, marginal revenue will be increasing.

(ii) When total revenue increases at a diminishing rate, marginal revenue will decreases, but will remain positive.

iii) When total revenue increases at a constant rate, marginal revenue will constant.

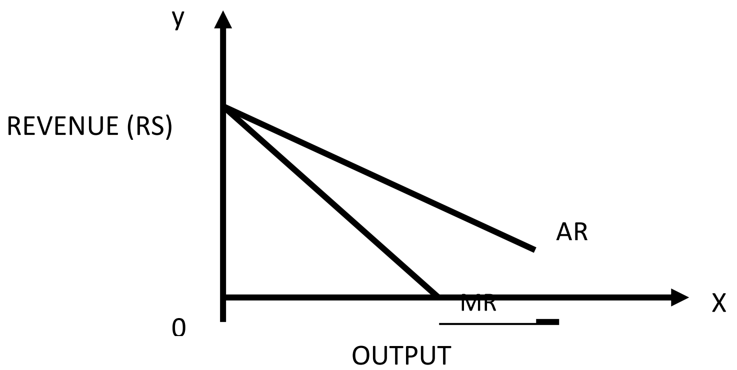
Q3. Draw AR & MR Curve under perfect competition.

Ans.



Q4. Draw AR & MR Curve under monopoly.

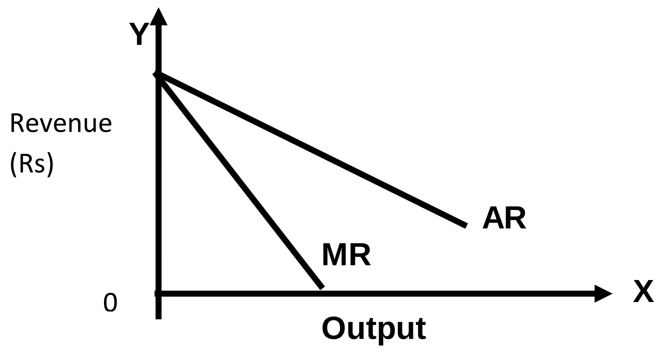
Ans. Revenue curves under monopoly



Q5. Draw AR & MR Curve under monopolistic market.

Revenue curves under monopolistic:

Ans.



LONG ANSWER TYPE QUESTIONS (6 MARK)

Q1. Explain the relationship between TR, MR & AR with the help of data & diagram?

ANS. **SCHEDULE**

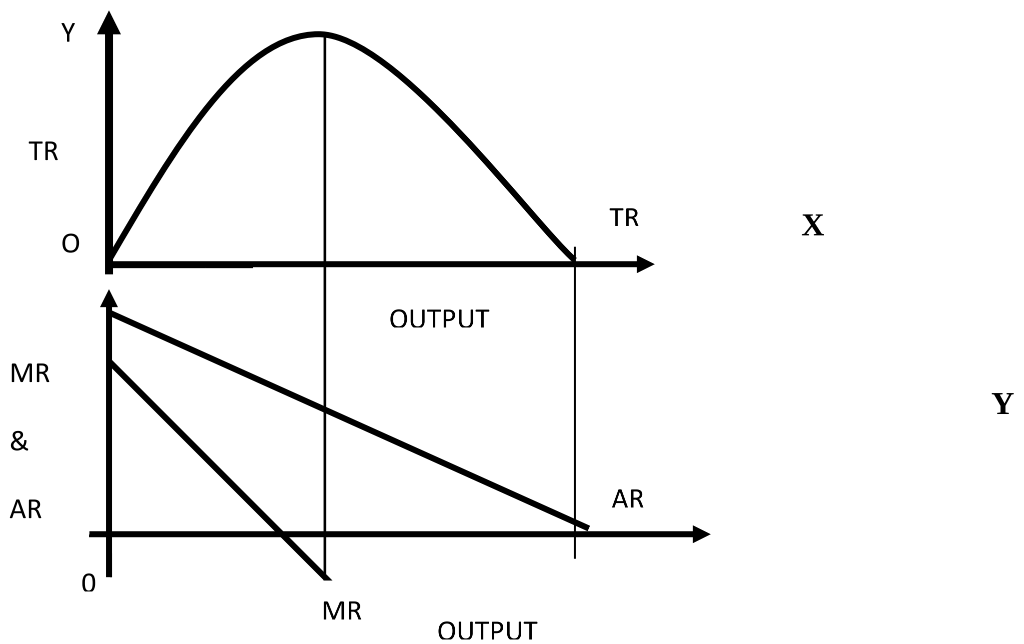
Output	price	TR	MR	AR
1	10	10	10	10
2	9	18	8	9
3	8	24	6	8
4	7	28	4	7
5	6	30	2	6
6	5	30	0	5
7	4	28	-2	4

Relationship between TR & MR(when price falls with rise in output)

1) When TR rises, MR is positive.
2) When TR is maximum, MR is zero.
.3) when TR is decreasing, MR is negative.
4) TR = ∑MR

Relationship between MR&AR (when price falls with rise in output)

1. Both MR and AR fall with rise in output.
2. MR falls at rate which is twice the rate of fall in AR.
3. MR may be positive, zero or negative but AR always positive.

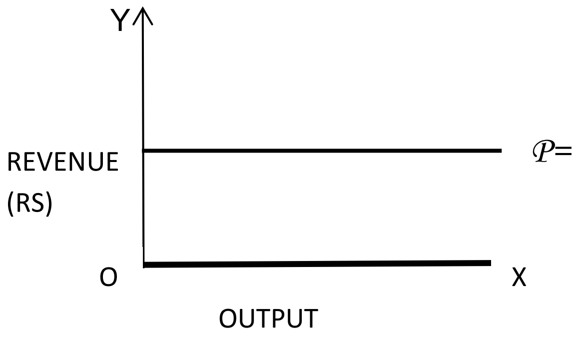


Relationship between TR & MR (when price remains constant)

OUTPUT	Price	TR	MR	AR =P
1	5	5	5	5
2	5	10	5	5
3	5	15	5	5
4	5	20	5	5

Since MR constant, TR also increases at a constant rate

Relationship between MR& AR (when price remains constant



AR = MR and both the curves coincide in a horizontal straight line parallel to the X – axis.

Q2: Complete the following table:

Output (units)	Total revenue(Rs.)	Marginal Revenue (Rs.)	Average Revenue(Rs.)
1	14	________	________
2	24	________	________
3	24	________	________
4	16	________	________

Ans.

Output(units)	Total Revenue(Rs.)	Marginal Revenue(Rs.)	Average revenue(Rs.)
1	14	14	14
2	24	10	12
3	24	0	8
4	16	-8	4

Q3.Complete the following table:

Price(Rs.)	Output(units)	Total Revenue(Rs.)	Marginal Revenue(Rs.)
7	–	7	–
–	2	10	–
–	3	–	-1
1	–	–	-5

Ans.

Price(Rs.)	Output(units)	Total Revenue(Rs.)	Marginal Revenue(Rs.)
7	1	7	7
5	2	10	3
3	3	9	-1
1	4	4	-5

FORMULAS

- TR = AR * Q & TR= Total Revenue
- **MR = TR_n- TR_{n-1} MR= Marginal Revenue**

- **AR = TR / Q** **AR = Average Revenue**

CONCEPT OF COST

VERY SHORT ANSWER TYPE QUESTIONS (ONE MARK EACH)

Q1. What is meant by cost of production?
Ans. Cost is the expenditure incurred by the producer on purchases of factor input such as land, labour, capital, etc., and non-non factor inputs such as raw material, fuel etc.

Q2. What is meant by total cost?
Ans. Total cost refers to all expenses incurred by the producer to produce a given quantity of output.
Total Cost (TC)= Total Fixed Cost (TFC)+Total Variable Cost(TVC)

Q3. What is meant by average cost?
Ans. Average cost is the cost per unit of output producer.
$$AC=TC/Q$$
Also, $AC= AFC+AVC$

Q4. Define marginal cost?

Ans. Marginal cost is the change in total cost by producing one more or less unit of output.
$MC_n=TC_n-TC_{n-1}$ **Also,** $MC=\Delta TC/\Delta Q$

Q5. Define fixed cost?

Ans. Fixed or supplementary costs are those costs which do not change with change in the level of output.

Q6. What is meant by prime and variable cost?

Ans. Prime and variable costs are those costs which change as the level of output changes.

Q7. What is the general shape of AFC curve?

Ans. The shape of AFC curve is a rectangular hyperbola.

Q8. Give two examples of fixed cost.

Ans. Cost incurred on the building and income given to the manager of the firm.

Q9. Why is short run average cost curve (AC curve) U shaped?

Ans. short run average cost curve (AC curve) U shaped because of the law of variable proportion.

Q10. If TC=30 ,TFC=20, what is the value of TVC?

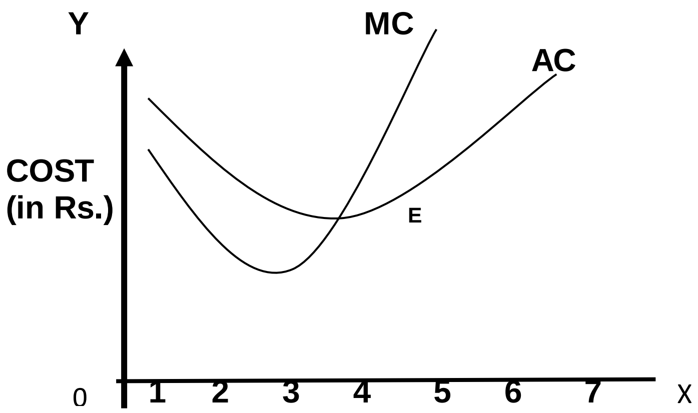
TVC = TC – TFC, 30 – 20 = 10, so TVC=10

SHORT ANSWER TYPE QUESTIONS (3&4 MARKS)

Q1. Differentiate between fixed and variable cost?
ANS.

VARIABLE COST	FIXED COST
Fixed cost is the Expenditure incurred By the producer on the purchase of fixed Factor.	Variable cost is the expenditure incurred by the producer on the use of variable factor.
Fixed cost does not change with the quantity of output.	Variable cost change with change With quantity of output.
Fixed cost remains the same whether output is zero or maximum.	Variable cost is zero when output is zero.
Rent, wages of permanent Staff.	Cost of raw material, wages of Casual labour.

Q9. Explain the relation between average cost & marginal cost with the help of diagram?
ANS.



OUTPUT

Relation between average cost and marginal cost

1. **Both AC and MC are calculated from TC.**
2. **When MC is lass than AC, AC falls with increase in the output.**
3. **When MC becomes equal to AC, AC is constant and at its minimum point.**
4. **When MC is more than AC, AC rises with increase in output.**

Q10. What does the average fixed cost curve look like? Why does it look so?

Ans. The average fixed cost (AFC) curve look like a rectangular hyperbola. It happens because same amount of fixed cost is divided by increasing output. As a result, AFC curve slope downward and is a rectangular hyperbola, i.e. area under AFC curve remain same at different points.

When AC falls, MC is lower than AC.
When AC rises, MC is greater then AC.
MC cuts AC at its lowest point.

Q10. Give meanings of: (i) Explicit cost & (ii) Implicit cost

Ans. EXPLICIT COST: Explicit costs are those cash payments which firms makes to outsider for the purchase of goods and services. For e.g.: wages paid to labourers' & price of raw materials.

IMPLICIT COST: Implicit costs are opportunity cost of self-owned and self-employed resources. For e.g.: interest on entrepreneur's own capital or rent on Entrepreneur's own building.

Q11. From the following table, calculate average variable cost of each given level of output:

Output(units)	1	2	3	4
Marginal cost (Rs.)	70	60	62	72

Ans.

Output(units)	Marginal cost(Rs.)	Total variable cost(Rs.)	Average variable cost(Rs.)
1	70	70	70
2	60	130	65

3	62	192	64
4	72	264	66

Q12. Complete the following table:

Output(units)	Total variable cost(Rs.)	Average variable cost(Rs.)	Marginal cost(Rs.)
1	_	12	_
2	20	_	_
_	_	10	10
4	40	_	_

Ans.

Output(units)	Total variable cost(Rs.)	Average variable cost(Rs.)	Marginal cost(Rs.)
1	12	12	12
2	20	10	8
3	30	10	10
4	40	10	10

LONG ANSWER TYPE QUESTIONS (6 MARK)

Q1. A firm's total cost schedule is given in the following table:

Output(units):	0	1	2	3	4	5	6	7	8
Total cost (in Rs.)	40	120	170	180	210	260	340	440	550

(1).what is the total fixed cost of this firm?

(2).drive AFC,AVC, ATC and MC schedules.

Ans.since at zero level of output total cost is 40,this is the firm's total fixed cost.

Output (units)	TC(Rs.)	TFC(Rs.)	TVC(Rs.)	AFC(Rs.)	AVC(Rs.)	ATC(Rs.)	MC(Rs.)
0	40	40	_		_		_
1	120	40	80	40	80	120	80
2	170	40	130	20	65	85	50
3	180	40	140	13.33	46.67	60	10
4	210	40	170	10	42.5	52.5	30
5	260	40	220	8	44	52	50
6	340	40	300	6.67	50	56.67	80
7	440	40	400	5.71	57.14	62.85	100
8	550	40	510	5	63.75	68.75	110

UNIT - 3

PRODUCER`S EQUILIBRIUM

VERY SHORT ANSWER TYPE QUESTIONS (ONE MARK EACH)

Q1. Who is a producer?

Ans. A producer is a producing unit who uses factor inputs to produce goods which have exchange value.

Q2. What is meant by producer's equilibrium?

Ans. Producer is said to be in equilibrium when he maximizes his profits and minimizes his loses. It occurs when (i) MR=MC and MC is rising.

Q.3 What is general profit maximizing condition of a firm?
Ans. MC = MR

Q.4 What is meant by producer's equilibrium?

Ans. It can be defined as that level output at which a firm gets maximum profits.

Q.5 What is Break even point?

Ans. Break- even point TR = TC

Q.6 What is shut down point?

Ans. Shut down point TR = TVC

SHORT ANSWER TYPE QUESTIONS (3&4 MARKS)

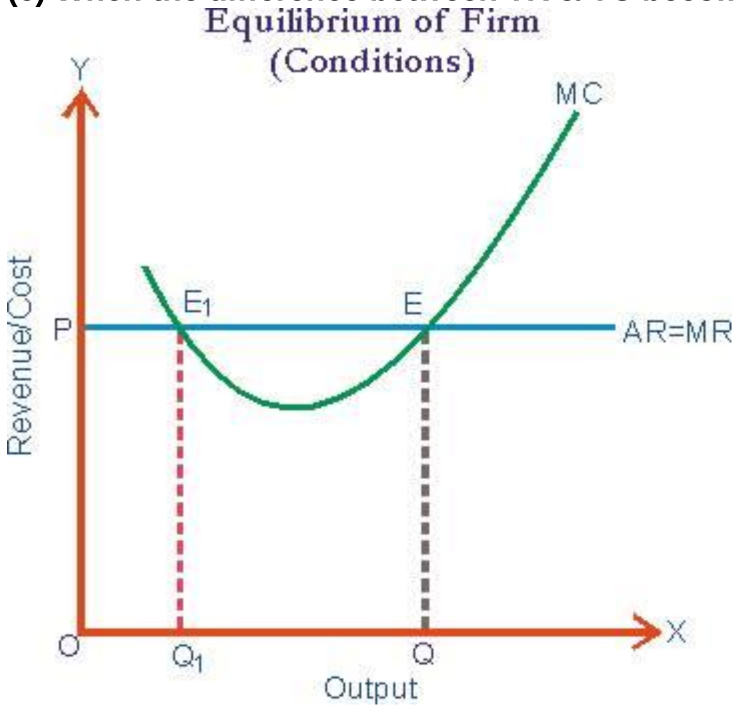
Q1. What is the condition of producer's equilibrium for a competitive firm?
Ans. A competitive firm attains equilibrium when its price is equal to its marginal cost.

P=MC

A competitive firms profit is maximized and it is in equilibrium where MC curve cuts MR curve from below.

P = MC = MR

Q2. What is meant by producer's equilibrium?
Ans. Producer's equilibrium is the situation in which the producer maximize his profits and minimizes his loss. A producer will be under equilibrium condition when.
(a) MC = MR
(b) MC cuts the MR curve from below.
(c) When the difference between TR & TC becomes maximum.



Q3.Is it enough to say that profit is maximized when MC=MR?
Ans. No, it is necessary to fulfill both the conditions for equilibrium
I. MR = MC
II. MC curve cut MR curve from below that is MC rising after equilibrium.

Q4. If MC is more than MR at a particular level of output, then how will a producer react to maximize the profit?

Ans. Producer will decrease the production to maximize the profit. Reduction in the production will be done till he reaches when MR =MC.

LONG ANSWER TYPE QUESTIONS (6 MARK)

Q1. Explain producer's equilibrium with the help of MR - MC approach.

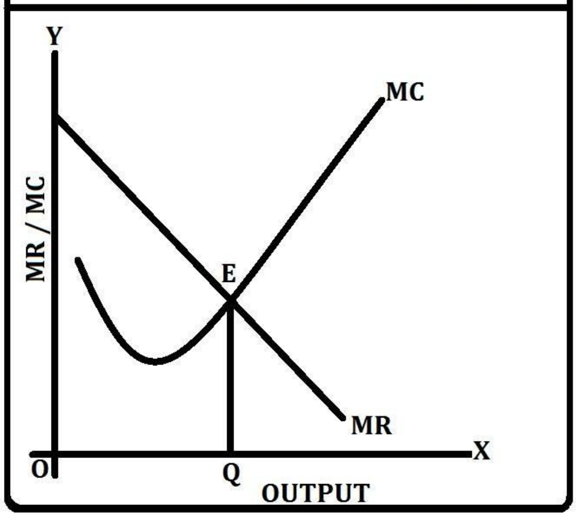
Ans. The producer's equilibrium refers to the situation in which he maximizes his profits.

Profits = TR-TC

OUTPUT	PRICE(Rs.)	TR (Rs.)	TC(Rs.)	MR (Rs.)	MC (Rs.)	PROFIT= (TR-TC)(Rs.)
1	8	6	6	8	6	2
2	7	14	11	6	5	3
3	6	18	15	4	4	3
4	5	20	20	2	5	0
5	4	20	26	0	6	-6

Producer is in equilibrium at 3rd level of output, because both the conditions of equilibrium are satisfied at 3 units of output.

Profit Maximisation by MR-MC Approach



Q2. A firm has been operating in the market for a long time. Its profit has been falling considerably. The producer is not able to decide whether to continue with the operation or exit the industry. As a student of economics, suggest him the way.

ANS: It is clear from the question that the price charged by the firm is less than the average cost incurred by it. The firm has to ensure the following and accordingly the decision to leave or stay in the operation can be taken:

- **i) If the firm is able to recover average variable cost fully and average fixed cost partially than it may stay in the business and review its plan and policies to reduce the losses.**
- **ii) If variable cost is recovered and average fixed cost is not at all recovered the firm should close down its operation it is shutdown point for the firm.**

SUPPLY

<u>VERY SHORT ANSWER TYPE QUESTIONS (ONE MARK EACH)</u>

Q1. What causes a downward movement along a supply curve of a commodity?

Ans : Increase in cost of production

Q2. What causes an upward movement along the supply curve of a commodity?

Ans: Decrease in excise duties.

Q3. What causes a movement along the supply curve of a commodity?

Ans : change in price of goods.

Q4. State the law of supply.

Ans : The law states that as price of a good rises, quantity rises, while other things remain constant.
:
Q5. A firm raises its supply without any incentive of rise in price, mention three reasons.

Ans. (i) Improvement in technique in production.
(ii) Fall in factor pricing.
(iii)Subsidies provided by the state.

Q6. An electronic company has enough periods to raise the supply of A. C's. what type of elasticity of supply it will have?

Ans. Elastic

Q7. Demand for a good is elastic whereas its supply is inelastic. What impact it will have, when demand for good increases? Explain.

Ans. When supply is inelastic, it means supply for such a product cannot be increased. Now when demand for it increases, it will raise price for such a good.

Q8. "Supply of agricultural goods is inelastic". Explain.

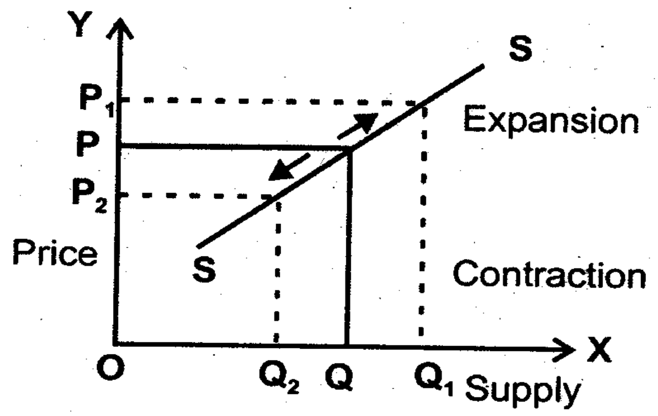
Ans. Yes, it is true that supply of agricultural goods is inelastic because it is not inspired by price-rise rather it depends upon natural, climatic and biological factors. Such goods take lot of time in its production, therefore no price-frame can guide there production.

Q9. Imports of production with less elastic supply can fetch higher revenue. Explain.

Ans. True, those imported goods which are inelastic or less elastic like petrol and diesel and can fetch higher revenue. It is because of the reason that such goods will be sold at high price because of limited supply. Therefore, the yield from such import will be higher.

Q10. Distinguish between Change in Quantity Supplied and Change in Supply

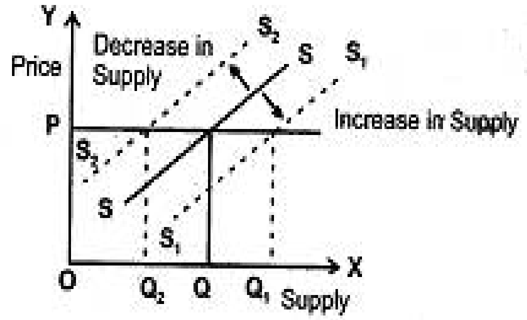
Change in Quantity Supplied: When there is change in supply of a commodity due to change in price (This is movement along the supply curve)
This Change is of two types.
1) Expansion in supply -Supply increases due to increase in price
2) Contraction in supply -Supply decreases due to decrease in price.



Change in Supply-(Shift in supply curve) When supply of a commodity changes due to factors other than price, like technique, taxation policy, prices of factors of production etc. This is called change in supply.
This change is of two types:

a) Increase in supply -when supply of a commodity rises due to factor other than price it is increase in supply. In this case the supply curve shifts rightward.

b) Decrease in supply -when supply of a commodity falls due to factors other than price it is decrease in supply. In this case the entire supply curve shifts to the left.



Q12. Explain the law of supply.

Law of Supply: Other things being constant, there is a direct relation between price of a commodity and its quantity supplied i.e. higher the price more the supply and vice-versa.
Assumptions of law of supply
1. No change in price of other goods.
2. No change in technology.
3. No change in price of factors of production.
4. Goal of the producer remain same.

Supply Schedule: It is a schedule / table showing different quantities supplied of a commodity by a seller at different prices.

Price	Supply
1	10
2	20
3	30
4	40
5	50

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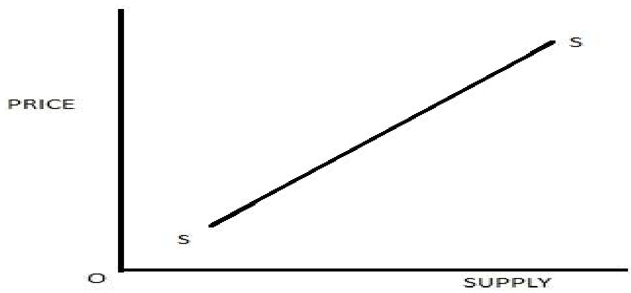

UNIT 4: FORMS OF MARKET AND PRICE DETERMINATION UNDER COMPTITION WITH SIMPLE APPLICATIONS

VERY SHORT ANSWER TYPE QUESTIONS(ONE MARK EACH)

Q1. Define market.

Ans._ Market is a place in which buyers and sellers come into contact for the purchase and sale of goods and services.

Q2. Define equilibrium:

Ans._It means a position of rest, there is no tendency to change.

Q3. What do you mean by market equilibrium?

Ans. It means equality between quantity demanded and quantity supplied of a commodity in the market.

Q4. Define market demand

Ans. It refers to the sum total demand for a commodity by all buyers in the market.

Q5. Define market supply

Ans. Market supply: It refers to supply of a commodity by all the firms in the market.

Q6. Define perfect competition.

Ans:- Perfect competition is a market with large number of buyers and sellers , selling homogeneous product at same price.

Q7. Define monopoly.

Ans: Monopoly is a market situation dominated by a single seller who has full control over the price.

Q8. Define monopolistic competition.

Ans:- It refers to a market situation in which many buyers and sellers selling differentiated product and have partial control over the price.

Q9. Under which market form firm is a price maker?
Ans:- Monopoly

Q10. What are selling cost?
Ans:- Cost incurred by a firm for the promotion of sale is known as selling cost. (Advertisement cost)

Q11. What is oligopoly?

Ans:- Oligopoly is defined as a market structure in which there are few large sellers who sell either homogenous or differentiated goods.

Q12. In which market form is there product differentiation?
Ans:- Monopolistic competition market and oligopoly market.

Q13. What is product differentiation?
Ans: It means close substitutes offered by different producers to show their output differs from other output available in the market. Differentiation can be in colour, size packing, brand name etc to attract buyers.

Q14. What do you mean by patent rights?
Ans:- Patent rights is an exclusive right or license granted to a company to produce a particular output under a specific technology.

Q15. What is price discrimination?
Ans: - It refers to charging of different prices from different consumers for different units of the same product.

Q16. What is the shape of marginal revenue curve under monopoly?
Ans:- Under monopoly market MR curve is downwards sloping curve form left to right and it lies below the AR curve.

Q17. What do you mean by abnormal profits?

Ans:- It is a situation for the firm when TR > TC.

Q18. Why AR is equal to MR under perfect competition?
Ans:- AR is equal to MR under perfect competition because price is constant.

Q19. What are advertisement costs?
Ans: - Advertisement cost are the expenditure incurred by a firm for the promotion of its sales such as publicity through TV , Radio , Newspaper , Magazine etc.

Q20. What is short period?
Ans:- Short period refers to that much time period when quantity of output can be changed only by changing the quantity of variable input and fixed factors remaining same.

Q21. Define long period.
Ans:- Long period refers to that much time period available to a firm in which it can increase its outputs by changing its fixed and variable inputs.

Q22. What is market period?
Ans: Market period is defined as a very short time period in which supply of commodity cannot be increased.

Q23. What is meant by normal profit?
Ans:- Normal profit is the minimum amount of profit which is required to keep an entrepreneur in production in the long run.

Q24. What is break-even price?
Ans:-In a perfectly competitive market, break- even price is the price at which a firm earn normal profit (Price=AC). In the long run, Break- even price is that price where P=AR=MC

Q25.What happens to equilibrium price if demand increase?

Ans. Equilibrium price increases.

Q26. Define perfect competition market.
Ans. A market where there are large no. of buyer and seller dealing in a homogenous product at the same price.

Q27. What is the shape of demand curve of perfect competition market?
Ans. Demand curve is indicated by the Horizontal straight line parallel to the X – axis.(perfectly elastic)

Q28. Under which market forms, firm is a price taker?
Ans. Perfect competition market.

Q29. Under which market firm is price maker?
Ans. Monopoly.

Q30. What is the shape of demand curve in a monopoly market?
Ans. demand curve under monopoly is negatively sloped.

Q31. Why is demand curve under monopolistic competition market elastic?
Ans. Because differentiated products under monopolistic competition have close substitute.

Q32. What is oligopoly market?
Ans. Refers to a market situation in which there are a few firms selling homogeneous or differentiated products.

Q33. What is shape of demand curve in cash of oligopoly market?
Ans. Indeterminate demand curve.

Q34. What is cartel?
Ans. Cartel is a group of firms which jointly set their output and price so as to exercise monopoly power.

Q35. What is shape of MR curve in case of perfectly competitive market.
Ans. MR curve is indicated by the Horizontal straight line parallel to the X – axis.

Q36. In which market AR= MR.
Ans. Perfectly competitive market.

3 & 4 MARKS QUESTION:

Q1. Explain any four characteristics of perfect competition market.

Ans:-

i) Large number of buyers and sellers: The number of buyers and sellers are so large in this market that no firm can influence the price.

ii) *Homogeneous products:* Products are uniform in nature. The products are perfect substitute of each other. No seller can charge a higher price for the product. Otherwise he will lose his customers.

iii*) Perfect knowledge:* Buyers as well as sellers have complete knowledge about the product.

iv) *Free entry and exit of firm:* Under perfect competition any firm can enter or exit in the market at any time. This ensures that the firms are neither earning abnormal profits nor incurring abnormal losses.

Q2. What are the reasons which give emergence to the monopoly market?

Ans: - i) Patent Rights: Patent rights are the authority given by the government to a particular firm to produce a particular product for a specific time period.

ii) Formation of Cartel: Cartel refers to a collective decision taken by a group of firms to avoid outside competition and securing monopoly right.

iii) Government licensing: Government provides the license to a particular firm to produce a particular commodity exclusively.

Q3. How does increase in price of substitute goods in consumption affect the equilibrium price of a good? Explain with a diagram.

Ans:- An increase in price of substitute goods (coke) will cause increase in demand for its related goods (Pepsi) . The demand curve for Pepsi will shift to the right side. The supply curve of Pepsi remains the same. It will lead to an increase in equilibrium price of Pepsi and increase in quantity also.

Q4. How does the equilibrium price of a normal commodity change when income of its buyers falls? Explain the chain effects.

Ans:-

 When income falls demand falls

 Supply remaining unchanged .There is excess supply at a given price

 This leads to competition among sellers to reduce the price.

 As a result demand starts rising and supply starts falling.

 These changes continue till a new equilibrium price is established where demand equal supply.

 Equilibrium price falls.

Q5. What do you mean by perfect competition market? explain its features.

Ans: - Perfect competition: refers to a market situation in which there are large number of buyers and sellers. Firms sell homogeneous products at a uniform price.

Features of perfect competition:

1. Very large number of buyers and sellers.
2. Homogeneous product.
3. Free entry and exit of firms.
4. Perfect knowledge.
5. Firm is a price taker and industry is price maker.
6. Perfectly elastic demand curve (AR=MR)
7. Perfect mobility of factors of production.
8. Absence of transportation cost
9. Absence of selling cost.

Q6. What do you mean by Monopoly market? explain its features

Ans. Monopoly market: Monopoly is a market situation dominated by a single seller who has full control over the price.

Features of monopoly:

1. Single seller of a commodity.
2. Absence of close substitute of the product.
3. Difficulty of entry of a new firm.
4. Negatively sloped demand curve(AR>MR)
5. Full control over price.
6. Price discrimination exists

7. Existence of abnormal profit.

Q7. What do you mean by Monopolistic competition market? Explain its features.

Ans. Monopolistic competition: It refers to a market situation in which there are many firms who sell closely related but differentiated products.

Features of monopolistic competition

1. Large number of buyers and sellers but less than perfect competition.

2. Product differentiation.

3. Freedom of entry and exit.

4. Selling cost.

5. Lack of perfect knowledge.

6. High transportation cost.

7. Partial control over price

Q8. What do you mean) Oligopoly market? Explain its features.

Ans. Oligopoly: is a market structure in which there are few large sellers of a commodity and large number of buyers.
Main features of Oligopoly.

1. Few dominant firms who are large in size

2. Mutual interdependence.

3. Barrier to entry.

4. Homogeneous or differentiated product.

5. Price rigidity.

Q9. Explain any four characteristics of perfect competition market.

Ans:-
i) Large number of buyers and sellers : The number of buyers and sellers are so large in this market that no firm can influence the price.
ii) Homogeneous products: Products are uniform in nature. The products are perfect substitute of each other. No seller can charge a higher price for the product. Otherwise he will lose his customers.

iii) Perfect knowledge: Buyers as well as sellers have complete knowledge about the product.
iv) Free entry and exit of firm: Under perfect competition any firm can enter or exit in the market at any time. This ensures that the firms are neither earning abnormal profits nor incurring abnormal losses.

10. What are the reasons which give emergence to the monopoly market?

Ans:-i) Patent Rights: Patent rights are the authority given by the government to a particular firm to produce a particular product for a specific time period.
ii) Formation of Cartel: Cartel refers to a collective decision taken by a group of firms to avoid outside competition and securing monopoly right.
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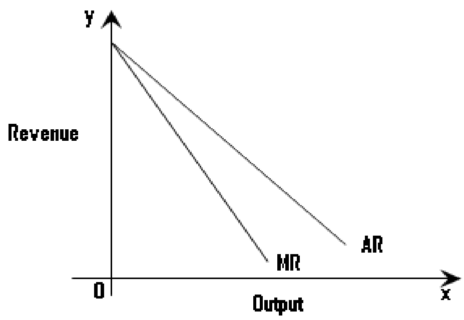
Ans:-
- **When income falls demand falls**
- **Supply remaining unchanged .There is excess supply at a given price**
- **This leads to competition among sellers to reduce the price.**
- **As a result demand starts rising and supply starts falling.**

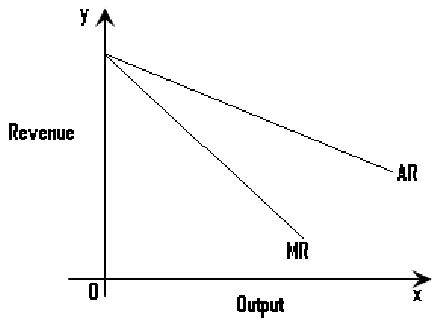
 These changes continue till a new equilibrium price is established where demand equal supply.

 Equilibrium price falls.

Q13. How are revenue curves different under monopoly from monopolistic competition and why?

AR and MR curves under monopoly and monopolistic competition are downward sloping but more elastic under monopolistic competition.





Monopoly   Monopolistic Competition

Revenue curve are more elastic under monopolistic competition because close substitutes are available.

Q14. Firm under monopolistic competition spend huge amount on advertisement. It is for create brand image in the mind of consumers. Justify.

Ans. It is not always justified. As far as selling cost incurred to give information or create awareness or to persuade consumers are distinguish of the product it is desirable. If it turns defensive and firms start incurring huge amount of money increasing total cost than it is not desirable because this high cost is passed on to consumer in the form of high prices.

Q15. In monopoly how firms increase the sale without reducing the price?

Ans. sales can be increased by non-price competition through advertising, discounts, free gifts etc.

Q16. Can you give some suggestions to the firm to maximize profit in perfect competition market?

Ans. Price determination

Q17.Equilibrium price of a medicine is too high. Explain what possible steps can be taken to bring down the equilibrium price but only through market force.

Ans. Even though competitive price is equilibrium price however it may be though for a set of consumer or too low for a set of producer hence government intervention in form of fixation of prices assumes important to ensures welfare of all

Q18. If government reduce subsidies o LPG cylinder how does it affect its market price?

Ans. Market price will be reduced

Q19. Explain briefly why a firm under perfect competition is a price taker not a price maker?

Ans- A firm under perfect competition is a price taker not a price maker because the price is determined by the market forces of demand of supply. This price is known as equilibrium price. All the

firms in the industry have to sell their outputs at this equilibrium price. The reason is that, number of firms under perfect competition is so large. So no firm can influence the price by its supply. All firms produce homogeneous product.

Q20. What are the reasons which give emergence to the monopoly market?

Ans- The main reasons are as under) Patent Rights- Patent rights are the authority given by the government to a particular firm to produce a particular product for a specific time period.

ii) Formation of Cartel- Cartel refers to a collective decision taken by a group of firms to avoid outside competition and securing monopoly right.

iii) Government licensing- Government provides the license to a particular firm to produce a particular commodity exclusively

Q21. Why is demand curve facing a monopolistic competition firm likely to be more elastic?

Ans- In monopolistic competition market the demand curve of a firm is likely to be more elastic, the reason behind this is that all the firm in the industry produce close substitute of each other. If close substitute of any good is available in the market then elasticity of demand is very high because whenever there is a hike in price the consumer will shift to its substitutes. That is why a firm‘s demand curve under monopolistic competition is more elastic.

Q22. Explain how the efficiency may increase if two firms merge.

Ans-When two firms merge then there combined efforts and efficiency brings more output to the firm. Increase in the sale of output and economies of scale can be availed. It leads to division of labour and can get advantage of the specialization. Use of better and advanced technology saves the cost of production.

Q23. Explain the implication of the feature product differentiation under Monopolistic competition.

Ans- Product differentiation is a distinct feature of monopolistic market. It means that buyers differentiate between the products produced by different firms. Therefore, they are willing to pay different prices for the products of different firms. Different groups of buyers prefer products of 281 different firms. This gives an individual firm some monopoly power, i.e. power to influence the demand for its product by changing price.

Q24. Explain the implication of the feature freedom of entry & exit of firms under perfect competition.

Ans- Free entry and exit of firms: It means that there is no barrier for entry and exit of firms in the industry. This

freedom ensures that firms earn just the normal profits in the long run. If the existing firms earn above-normal profits, new firms enter in the industry, raise supply, which brings down the price. The profits fall till each firm is once again earning only the normal profits.

If the existing firms are having losses, the firms start leaving, supply falls and price goes up. The price continues to rise till the losses are wiped out and firms are just earning normal profits.

- UNIT 5 :- NATIONAL INCOME AND RELATED AGGREGATES

VERY SHORT ANSWER TYPE QUESTIONS(ONE MARK EACH)

Q1. Define Macroeconomics.

Ans. It is defined as study of economy as a whole.

Q2. Name two macro variables.

Ans- Money and banking, National Income or inflation, employment etc.

Q3.What is circular flow of income?

Ans. Circulation of Goods and Services in Economy.

Q4. Give two examples of injections and two examples of leakages.

Ans- Injection: Export, subsidy, investment Leakages: Import, taxes, savings

Q5. What is real flow?

Ans: - The flow of goods and services among the major sectors of the economy.

Q6.What is money flow?

Ans - : The flow of only monetary income as payments and receipts among the major sectors of the economy.

Q7. Define GDP Deflator.

Ans- : It is the ratio of nominal to real GDP

Q8.What is domestic income?

Ans-: It is the net money value of all final goods and services produced within the domestic territories of a country during the financial year.

Q9.Who is normal resident?

Ans:- A person or institution whose economic interest lies in that country. A branch of SBI located in Singapore is normal resident of India.

Q10.What is depreciation?

Ans: - Fall in the value of fixed assets due to normal wear and tear, passage of time or expected obsolescence(change in technology).

Q11.What do you mean by value added?
Ans- Value added= Value of output – intermediate purchase.

3 & 4 MARKS QUESTION:

Q1. Distinguish between domestic income and national income.

Ans: - **Domestic Income**: - income earned in domestic economic territory in a financial year. It does not include net factor income earned from abroad.
National Income: - Factor income earned by the normal residents of the country in a financial year. It includes net factor income earned from abroad.
Q2. Distinguish between factor income and transfer income.

Ans: - **Factor income**-Income received by factors of production for rendering factor services in the production process. It is included in both national income and Domestic income. eg. Rent, Interest, Wages, Profits. It is included in the national income accounting.
Transfer income- Income received without rendering any productive services in reterns.it is one sided payment eg. Old age pension, scholarship etc. It is not included in national income.

Q3. Distinguish between leakage and injection.
Ans- **Leakages from CIRCULAR FLOW of income**
1. These flow variables have a negative impact on the process of production.
2. These are withdrawals from the circular flow of income.
3. Examples: Saving, taxation and imports

Injections into from CIRCULAR FLOW of income
1. These causes positive impact on the process of production.
2. These are addition to the circular flow of income.
3. Examples: Investment, exports and consumption expenditure.

Q4. Distinguish between factor cost and market price.
Ans: - Product at Factor Cost

1. It is the Income earned by all the factors of production in a financial year.
2. It does not include Indirect taxes
3. Product at Factor Cost= Product at Market Price – Net Indirect taxes
Product at Market Price
1. It is the Market Value of all final goods and services produced in a financial year
2. It includes Indirect taxes
3. Product at Market Price =Product at Factor Cost +Net Indirect taxes

Q5. Distinguish between National Income and Private Income.
National Income
1. Factor income earned by the normal residents of the country in a financial year.
2. It does not include national debt interest.
3. It includes factor income of government sector

Private Income
1. Income of private sector from all sources (Factor income + transfer income).
2. It includes national debt interest.
3. It does not include factor income of government sector.

Q6. What do you mean by net factor income from abroad? **Explain its components**
<u>Net factor income from abroad</u>: **Difference between the factor incomes earned by our residents from abroad and factor income earned by non-residents within our country. Factor income earned by non-residents is also known as the factor income to abroad.**
NFIA = FIFA – FITA
Where, FIFA = Factor income from abroad.
FITA = Factor income to abroad.
Components of Net factor income from abroad
Net compensation of employees
Net income from property and entrepreneurship (other than retained earnings of
resident companies of abroad)
Net retained earnings of resident companies abroad
3- 4 Mark Questions and answers

Q7. Distinguish between GDPMpand GNP FC

Ans. The difference between both arise due to (1) Net factor income from abroad. and 2) Net indirect taxes. In GDPMp Net factor income from abroad is not included but it includes net indirect taxes.

GNP FC = GDP mp + net factor income from abroad – net indirect taxes

Q8. Distinguish between personal income and private income.

Ans. Personal income: -It is the sum total of earned income and transfer incomes received by persons from all sources within and outside the country.

Personal income = private income – corporate tax –corporate savings (undistributed profit)

Private income consists of factor income and transfer income received from all sources by private sectors within and outside the country.

Q9. Distinguish between nominal GNP and real GNP

Ans. Nominal GNP is measured at current prices. Since this aggregate measures the value of goods and services at current year prices, GNP will change when volume of product changes or price changes or when both changes.

Real GNP is computed at the constant prices. Under real GNP, value is expressed in terms of prices prevailing in the base year. This measure takes only quantity changes. Real GNP is the indicator of real income level in the economy.

Q10. Explain the main steps involved in measuring national income through product method.

Ans. a) Identification and classification of producing units into different sectors like primary, secondary and tertiary sectors.

b) Estimate value of output by sales + change in stock

c) Estimate gross value added by value of output – intermediate consumption

d) Estimate the net value added at the factor cost of each sector

e) Add net value added at factor cost of all the three sectors to arrive at net value added at factor cost.(NDP at fc)

f) Add net factor income received from abroad to NDP Fc to obtain NNP FC which is national income

Q11.Explain the steps involved in calculation of national income through income method

Ans: a) Classify the producing enterprises into different sectors like primary, secondary and tertiary.

b) Estimate the factor income paid by the producing units in each sector i.e.

*Compensation of employees
*Operating surplus
*Mixed income of self employed

c) Add the factor income by all the sectors to arrive at the NDP Fc

(Which is called domestic income)

d) Add net factor income from abroad to the net domestic product at factor cost to arrive at the net national product at factor cost(National Income).

Q12. Explain the main steps involved in measuring national income through expenditure method.

Ans: a) Classify the economic units incurring final expenditure into distant groups like households, government, firms, rest of the world.

b) Estimate the following final expenditure by all economic units

Private final consumption expenditure
Government final consumption expenditure
Gross domestic capital formation
Net export

(Sum total of above gives GDPMp)

c) Deduct depreciation, net indirect taxes to get NDP Fc

d) Add net factor income from abroad to NDP Fc to arrive at NNP FC (National Income).

Q13. What are the precautions to be taken while calculating national income through product method (value added method)

Ans: a) Avoid double counting of production, take only value added by each production unit.

b) The output produced for self-consumption to be included

c) The sale & purchase of second hand goods should not be included.

d) Value of intermediate consumption should not be included

e) The value of services rendered in sales must be included.

Q14. Precautions to be taken while calculating national income through income method.

Ans-Income from owner occupied house to be included.

a) Wages & salaries in cash and kind both to be included.

b) Transfer income should not be included

c) Interest on loans taken for production only to be included. Interest on loan taken for consumption expenditure is non-factor income and so not included.

Q15. Precautions to be taken while calculations N.I under expenditure method.

Ans: a) Avoid double counting of expenditure by not including expenditure on intermediate product

b) Transfer expenditure not to be included

c) Expenditure on purchase of second hand goods not to be included.

Q16. Write down the limitations of using GDP as an index of welfare of a country

a) The national income figures give no indications of the population, skill and resources of the country. A country may be having high national income but it may be consumed by the increasing population, so that the level of people's wellbeing or welfare standard of living remains low.

b) High N. I may be due to greater area of the country or due to the concentration of some resources in out particular country.

c) National income does not consider the level of prices of the country. People may be having income but may not be able to enjoy high standard of living due to high prices.

d) High N. I may be due to the large contribution made by a few industrialists

e) Level of unemployment is not taken into account.

f) National income does not care to reduce ecological degradation. Due to excess of economic activity which leads to ecological degradation reduces the welfare of the people.

Hence GNP and economic welfare are not positively related. Income in GNP does not bring about increase in economic welfare.

Q17. 'Machine purchased is always a final good' do you agree? Give reason for your answer

Ans: Whether machine is a final good or not depends on how it is being used (end use). If machine is bought by a household, then it

is a final good. If machine is bought by a firm for its own use, then also it is a final good. If the machine is bought by a firm for resale then it is an intermediate good.

Q18. What is double counting? How can it be avoided?
Ans: Counting the value of commodities at every stage of production more than one time is called double counting.
It can be avoided by
a) taking value added method in the calculation of the national income.
b) By taking the value of final commodity only while calculating N.I

Q19. State whether following is true or false. Give reason for your answer.
a) Capital formation is a flow
True, because it is measured over a period of time.

b) Bread is always a consumer good.
False, it depends upon the end use of bread. When it is purchased by a household it is a
consumer good. When purchased by restaurant for making sandwich, it is an intermediate (producer) good.
c) Nominal GDP can never be less that real GDP
False. Nominal GDP can be less than the prices in the base year.
d) Gross domestic capital formation is always greater than gross fixed capital formation.
False, gross domestic capital formation can be less than gross fixed capital formation if change in stock is negative.

Q2O. Why are exports included in the estimation of domestic product by the expenditure method? Or
Can the gross domestic product be greater than the gross national product? Explain
Expenditure method estimates expenditure on domestic product i.e., expenditure on final goods and services produced within the economic territory of the country. It includes expenditure by residents and non residents both. Exports though purchased by non residents are produced within the economic territory and therefore a part of domestic product.
Domestic product can be greater than national product, if the factor income paid to the rest of the world is greater than the factor

income received from the rest of the world i.e, when net factor income received from abroad is negative.

Q21. What do you mean by stock and flow?

Ans.Stock : Stock means quantity of an economic variable which is measured at a particular point of time. It has no time dimension. It is a static concept. Wealth, water in a tank and inventories are the examples of stock.

Flow:Flow is that quantity of an economic variable which is measured during a period of time. It is dynamic concept and has time dimension like per hour, per month etc. Investment, water in a stream and changes in inventories are the examples of flow.

Q22. How will you treat the following while estimating domestic product of India?

a) Rent received by resident Indian from his property in Singapore.

No, it will not be included in domestic product as this income is earned outside the economic territory of India.

b) Salaries if Indians working in Japanese Embassy in India.

It will not be included in domestic product of India as embassy of Japan is not a part of economic territory of India.

c) Profits earned by branch of American bank in India.

Yes, it is included as part of domestic product since the branch of American bank is located within the economic territory of India.

d) Salaries paid to Koreans working in the Indian embassy in Korea.

Yes, it will be part of domestic product of India because the income is earned within the economic territory of India. Indian embassy in Korea is a part of economic territory of India.

Q23. How are the following treated in estimating national income from expenditure method? Give reason.

a) Purchase of new car by a household:

Purchase of car is included in the national income because it is final consumption expenditure, which is part of national income.

b) Purchase of raw material by purchase unit:

Purchase of raw material by purchase unit is not included in the national income because raw material is intermediate goods and intermediate goods and service are excluded from the national income. Purchase of raw material, if included in national income will result in double counting.

c) Expenditure by the government on scholarship to student:

It is not included in the national income because it is a transfer payment and no productive service is rendered by the student in exchange.

Q24. Are the following item included in the estimating a country‘s national income? Give reason.

1) Free cloth given to workers:

Free cloth given to worker is a part of wages in kind i.e. compensation to employee such compensation to employee is paid for the productive services in the economy, it is included in the national income.

2) Commission paid to dealer in old car:

Commission paid to dealer in old car is included in the estimation of national income because it is the income of the dealer for his productive services to various parties.

3) Leave travel allowance paid to employees by a company.

Leave travel allowance paid to employees by a company, yes, it is a part of COE so it is included in national income.

NUMERRICALS

Q1.Calculate private income:-

ITEMS	(Rs.in cr)
Personal disposable income	300
Miscellaneous receipts of government	50
Corporate tax	10
Retained earnings of private sector	20
Personal tax	30

Ans- PDI= Private income – Corporate tax - Retained earnings of private sector- Personal tax - Miscellaneous receipts of government

300 X -10-20-30-50 , X= 410

Q2.Calculate NDP_{FC}

ITEMS	(Rs.in cr)
Subsidy	40
Sales	800
Depreciation	30
Exports	100
Closing stock	20
Opening stock	50
Intermediate purchase	50
Purchase of machinery for own use	200
Import of raw material	60

Ans- change in stock = Closing stock – opening stock
Value of output = sales + change in stock
Value Added = Value of output - Intermediate purchase
Value added = GDP_{MP}
NDP_{FC} = GDP_{MP} – depreciation – NIT (NIT = Indirect Tax – subsidy)
= 730, ANS. = 730 Cr

Q3. Calculate national income for the following data by income method and expenditure method:

ITEMS	(In crores)
(i) Interest	150
(ii) Rent	250
(iii) Government final consumption expenditure	600
(iv) Private final consumption expenditure	1200
(v) Profits	640
(vi) Compensation of employees	1000
(vii) Net factor income to abroad	30
(viii) Net indirect tax	60
(ix) Net export	(-) 40
(x) Consumption of fixed capital	50
(xi) Net domestic capital formation	340

Ans- Income method = Compensation of employees + Interest + Rent + Profits +Mixed income - Net factor income to abroad = Rs.2010Cr.

Expenditure method = Government final consumption expenditure + Private final consumption expenditure + Net domestic capital formation + Net export - Net indirect tax - Net factor income to abroad = Rs.2010Cr.

Q4. Calculate national income and Gross national disposable income for the following data:-

Items	(in crores)
(i) Net indirect tax	5
(ii) Net domestic fixed capital formation	100
(iii) Net imports	(-) 20
(iv) Government final consumption expenditure	200
(v) Net current transfers from abroad	15
(vi) Private final consumption expenditure	600
(vii) Change in stocks	10
(viii) Net factor income abroad	5
(ix) Gross domestic capital formation	125

Solution:

National income = (vi)+ (iv)+ (ii)+ (vii)- (iii)+ (viii)- (i)

600 +200 + 100 +10 – (-20) + 5 – 5 = Rs.930 Cr

Gross National Disposable Income = National income + (i) + (vi) + depreciation

930 + 5+ 15+ 25 = Rs. 975Cr.

Q5. From the following data, calculate National Product at Market Price by (i) income method and (ii) expenditure method: (6 marks)

items	(Rs. In Crores)
(i) Mixed income of self- employed	400
(ii) Compensation of employees	500
(iii) Private final consumption expenditure	900
(iv) Net factor income from abroad	(-) 20
(v)Net indirect tax	100
(vi) Consumption of fixed capital	120
(vii) Net domestic capital formation	280
(viii) Net exports	(-)30
(ix)Profits	350
(x)Rent	100
(xi)Interest	150
(xii) Government final consumption expenditure	450

Ans: (i) GNPMP = COE + R + I + P + Mixed I + NFIA + CFC + NIT +
(Income method) = ii + x + xi + ix + i + iv + vi + v
= 500 + 100 + 150 + 350 + 400 + (-20) + 120 + 100
= Rs. 1700 crores.
GNPMP = PFCE + GFCE + GDCF + Net X + NFIA
(Exp. Method) = iii + xii + (vii + vi) + viii + iv
= 900 + 450 + (280 + 120) + (-30) + (-20) = Rs. 1700 crores.

Q6. From the following data calculate national income by (a) income method and (b) expenditure method. (6 marks)

Items	Rs. (Crores)
(i) Private final consumption expenditure	2,000
(ii) Net capital formation	400
(iii) Change in stock	50
(iv) Compensation of employees	1,900
(v) Rent	200
(vi) Interest	150

(vii) Operating surplus 720
(viii) Net indirect tax 400
(ix) Employees' contribution to social security schemes 100
(x) Net exports 20
(xi) Net factor income from abroad (-)20
(xii) Government final consumption expenditure 600
(xiii) Consumption of fixed capital 100

Ans: N.I. (Income method) = iv + vii + xi
= 1900 + 720 + (-20) = 1900 + 720 – 20
= Rs. 2600 crores.

N.I. (Exp. Method) = i + xii + ii + x + viii + xi
= 2000 + 600 + 400 + 20 - 400 + (-20)
= 2000 + 600 + 400 + 20 – 400 - 20
= Rs. 2600 crores.

Q7. Will the following be a part of domestic factor income of India? Give reasons for your answers.
(6 marks)
(i) Old age pensions given by the Government.
(ii) Factor income from abroad
(iii) Salaries to Indian residents working in Russian Embassy in India.
(iv) Profits earned by a company in India, which is owned by a non-resident.

Ans:
(i) Old age pensions are not a part of domestic income because no factor service is rendered in return.
(ii) Factor income from abroad is not a part of domestic income because it is earned by the residents from outside the economic (domestic) territory.
(iii) Salaries to Indian residents working in Russian Embassy is not a part of domestic product of India because Russian embassy is a part of Russian economic territory. It is factor income from abroad.
(iv) Profits earned by a non-residential owned company in India is a part of domestic product of India because the income is created within the economic (domestic) territory of India

Q8. Will the following be included in National Income of India? Give reasons for your answer.
(6 marks)
(i) Financial help given to flood victims.
(ii) Profits earned by an Indian bank from its branches abroad.
(iii) Salaries paid to non-resident Indians working in Indian Embassy in America.
(iv) Interest received by an individual from banks.
Ans:
(i) Financial help is a transfer payment because no factor service is provided in return. It is, therefore, not included in national income.
(ii) Profit earned by an Indian bank from its branched abroad is factor income from abroad, and so included in national income.
(iii) Salaries paid to NRI's working in Indian embassy in America are factor income paid to abroad. It is not include in India's national income.
(iv) Interest received by individuals from banks is a factor payment by a productive enterprise. It is included in national income.
Q9. Will the following factor incomes be included in domestic factor income of India? Give reasons for your answer. (6 marks)
(i) Compensation of employees to the residents of Japan working in Indian embassy in Japan.
(ii) Profits earned by a branch of foreign bank in India.
(iii) Rent received by an Indian resident from Russian embassy in India.
Ans:
(i) It is a part of domestic factor income of India because the Indian embassy in Japan is a part of domestic territory of India.
(ii) It is a part of domestic factor income of India because the foreign bank is located in the domestic territory of India.
(iii) It is not a part of domestic income of India because Russian embassy in India is not a part of domestic territory of India.

HIGH ORDER THINKING SKILL

Q1. Machines purchased are not always final good. Explain.

Ans-When machines are purchased for final consumption, they are treated as final goods. E.g. washing machine purchased by a household for final use. When machines are purchased for resale

purpose, they are treated as intermediate goods. eg. Washing machine purchased by a mega store for resale.

Q2. National income is always greater than Domestic income. Defend or refute.

Ans- Refute, Because National income is greater than Domestic income only when NFIA is positive value. If Factor income received from abroad is less than the Factor income paid to abroad, national income will be less than Domestic income.

UNIT-6 MONEY AND BANKING

One mark questions:

Q1. Define money.

Ans. MEANING OF MONEY: Money is anything which is generally accepted as medium of exchange, measure of value, store of value and as means of standard of deferred payment.

Q2. Define commercial bank.

Ans. Commercial Bank: Bank is an institution which accepts deposits and advances loans with the view to earn profit.

3 - 4 MARKS QUESTIONS

Q1. What do you mean by barter system? What are its difficulties?

Ans. Barter System or C-C Economy- Direct exchange of goods for goods without the use of money. Difficulties of barter:

(i) Lack of double coincidence of wants,
(ii) Lack of a common measure of value,
(iii) Lack of store of value,
(iv) No proper accounting is possible.

Q3. Explain the functions of money.

Ans. FUNCTIONS OF MONEY: Functions of money can be classified into Primary and Secondary **Primary/Basic functions:-**

i) Medium of Exchange: - It can be used in making payments for all transactions of goods and services.
ii) Measure /Unit of value: - It helps in measuring the value of goods and services. The value is usually called as price. After knowing the value of goods in single unit (price) exchanges become easy.

Secondary functions:-

i) Standard of deferred payments: Deferred payments referred to those payments which are to be made in near future. Money acts as a standard deferred payment due to the following reasons:

a) Value of money remains more or less constant compared to other commodities.
b) Money has the merit of general acceptability.

c) Money is more durable compare to other commodity.

ii) Store of value: Money can be stored and does not lose value Money acts as a store of value due to the following reasons:

a) It is easy and economical to store.

b) Money has the merit of general acceptability.

c) Value of money remains relatively constant.

Q4. What is meant by money supply? Discuss, in brief, the various constituents of money supply.

Ans. MONEY SUPPLY: refers to total volume of money held by public at a particular point of time in an economy.

M1=currency held by public + Demand deposits + other deposits with Reserve Bank of India. M2=M1+saving deposits with post office saving bank

M3=M1+net time deposit with the bank

M4=M3 + total deposits with post office saving bank excluding national saving certificate

HIGH POWERED MONEY: Refers to, currency with the public (notes +coins) and cash reserve of banks.

Q.5 Explain the significance of the .Store of Value. function of money.

OR

State the importance of the .Store of Value function of money.

Ans. People save a part of their earnings for use in future. But in what form? Money fulfils this need of the people. Money as a store of value means that money is an asset and can be stored for use in future one can hold one.s earnings until the time one wants to spend it. This is the store of value function of Money.

Q.6 Explain the .Unit of Account. function of money?

Ans. The Unit of Account function of money is also called the .measure of value function. Money as a unit of account means a standard unit for quoting prices. It makes money a powerful medium of comparing prices of goods and services

Q.7 Explain the .Medium of Exchange function of money?

Ans. Money as a medium of exchange means money as a means of payment for exchange of goods and services. Goods and services are exchanged for money when people sell things. Money is exchanged for goods and services when people buy things. The medium of exchange function of money solves the problem of double coincidence of wants inherent in the barter system of trade.

Q.8 Explain the .Lender of Last Resort function of the central bank.

Ans. Central bank also lends money directly to commercial banks. Instead of rediscounting, central bank given loans against the bill of exchange promissory notes, treasury bills, government securities, etc. The direct lending to commercial bank is referred to as the .lender of the last resort function of central bank.

Q.9 Explain the .Government's Bank function of a central bank.

Ans. A central bank conducts the banking account of government departments. It performs the same banking functions for the government as commercial bank performs for its customers. It accepts their deposits and undertakes inter-bank transfers. It also gives loans to the government. A central bank also provides various services as agent of the government. It manages public debt. It also gives advice to the government regarding money market, capital market, government loans and economic policy matters.

6 - Marks Questions with Answers

Q1. What do you mean by central bank ?Explain the functions of central bank.

Ans. CENTRAL BANK

MEANING: An apex body that controls, operates, regulates and directs the entire banking and monetary structure of the country.

FUNCTIONS OF CENTRAL BANK:

i) Currency authority or bank of issue: Central bank is a sole authority to issue currency in the country. Central Bank is obliged to back the currency with assets of equal value (usually gold coins, gold bullions, foreign securities etc.,) Advantages of sole authority of note issue: a) Uniformity in note circulation b) Better supervision and control c) It is easy to control credit d) Ensures public faith e) Stabilization of internal and external value of currency

ii) Banker to the Government: As a banker it carries out all banking business of the Government and maintains current account for keeping cash balances of the government. Accepts receipts and makes payments for the government. It also gives loans and Advances to the government. 87

iii) Banker's bank and supervisor: Acts as a banker to other banks in the country— a) Custodian of cash reserves:- Commercial banks must keep a certain proportion of cash reserves with the central bank (CRR) b) Lender of last resort: -When commercial banks fail to need their financial requirements from other sources, they approach Central Bank which gives loans and advances. c) Clearing house: -Since the Central Bank holds the cash reserves of commercial banks it is easier and more convenient to act as clearing house of commercial banks.

iv) Controller of money supply and credit: - Central Bank or RBI plays an important role during the times of economic fluctuations. It influences the money supply through quantitative and qualitative instruments. Former refers to the volume of credit and the latter refers to regulate the direction of credit.

v) Custodian of foreign exchange reserve:-. Another important function of Central Bank is the custodian of foreign exchange reserves. Central Bank acts as custodian of country's stock of gold and foreign exchange reserves. It helps in stabilizing the external value of money and maintaining favourable balance of payments in the economy.

Q2. How can control the money supply in an economy? Explain different instruments of control of money supply.

Ans. 1) QUANTITATIVE INSTRUMENTS:

a) **Bank Rate policy:** - It refers to the rate at which the central bank lends money to commercial banks as a lender of the last resort. Central Bank increases the bank rate during inflation (excess demand) and reduces the same in times of deflation (deficient demand)

b) Open Market Operations: It refers to the buying and selling of securities by the Central Bank from/ to the public and commercial banks. It sells government securities during inflation/excess demand and buys the securities during deflation/deficient demand.

c) Legal Reserve Ratio: R.B.I. can influence the credit creation power of commercial banks by making changes in CRR and SLR

Cash Reserve Ratio (CRR): It refers to the minimum percentage of net demand and time liabilities to be kept by commercial banks with central bank.

i) Reserve Bank increases CRR during inflation and decreases the same during deflation 88 **Statutory Liquidity Ratio (SLR):** It refers to minimum percentage of net demand and time liabilities which commercial banks required to maintain with themselves.

SLR is increased during inflation or excess demand and decreased during deflation or deficient demand.

Reverse Repo Rate: Securities are acquired by the RBI from the commercial banks with a simultaneous commitment to re-sell them to the commercial banks at predetermined rate and date

2) QUALITATIVE INSTRUMENTS:

A . Margin Requirements: It is the difference between the amount of loan and market value of the security offered by the borrower against the loan. Margin requirements are increased during inflation and decreased during deflation.

B . Moral suasion: It is a combination of persuasion and pressure that Central Bank applies on other banks in order to get them act in a manner in line with its policy. 3. Selective credit controls: Central Bank gives direction to other banks to give or not to give credit for certain purposes to particular sectors.

Q1. What do you mean by credit/money creation? Explain the process of money creation by the commercial banks with the help of a numerical example.

Ans. The money creation by the commercial banks is determined by the amount of Initial deposit and the leagal reserve ratio (LRR).

The Working :
Suppose (i) Initial Deposit = Rs. 1000 (ii) LRR = 20%. The bank will keeps 20% ie Rs. 200 as cash reserve and lend the remaining Rs. 800. Banks do not land this money by giving amount in cash. Those who borrow will spend this money. It is assumed that Rs. 800 comes back to the bank.in the form of deposit accounts .it will increase the demand deposit of bank by Rs. 800. With new deposits of Rs. 800, banks keep 20% of Rs.800 as cash and land the balance Rs. 640This further raises the amount of deposits with the bank. In this way, deposits go on increasing in each round by 80%of the last deposit. The number of times, the total deposits will become, is determined by the depositor money multiplier:

	Deposits (Rs.)	**Loans (Rs.)**	**Cash reserve (Rs.)**
Initial deposit	1000	800	200
Round 1	800	640	160
Round 2	640	512	128
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total	5000	4000	1000

money multiplier: $= \frac{1}{LRR} = \frac{1}{0.2} = 5$

The total deposit will be : initial deposit x_ money multiplier =10000 x 5 = Rs. 5000

Commercial Bank:- Bank is an institution which accepts deposits and advances loans with the view to earn profit.

Q5. Define central bank? What are the functions of central bank?

Central Bank:- The apex institution which controls, operates, regulates, and directs the entire monetary system of the country.

Functions of Central Bank:

(i) Issue of Currency,
(ii) Banker to the government,
(iii)Banker's bank,
(iv)Controller of credit (Bank rate policy, open market operations, Variations in reserve ratio),
(v)Lender of last resort,
(vi) Custodian of foreign exchange of the country.

UNIT 7- DETERMINATION OF INCOME AND EMPLOYMENT

Q1. What is Aggregate demand?

Ans. The overall demand for the economy which is represented in terms of expenditure is called Aggregate demand.

Q2.What is the components of AD?

Ans: AD = C+ I+ G+ (X-M)

S= (-) C + (1-c)Y

Q2. What is aggregate supply?

ANS. It is the money value of all final goods and services available in an economy during an accounting year

Q3. Define voluntary unemployment.

Ans. A situation in which a person is not willing to work on existing wage rate is called voluntary unemployment.

Q4. Define involuntary unemployment.

Ans. It refers to a situation where able bodied persons are willing to work at the prevailing wage rate but unable to find job.

Q5. What is full employment?

Ans. It refers to a situation in which all those people, who are willing and able to work at the existing wage rate, get employment.

Q6. What is underemployment equilibrium?

Ans. It is a state of equilibrium when AS=AD, before full employment level.

Q7. What is consumption function?

Ans. It shows the relationship between consumption and income. C=f(Y)

Q8. Define MPC.

Ans. It is the ratio of change on consumption to change in income. MPC=ΔC / ΔY.

Q8. Define investment.

Ans. It refers to the addition to the stock of capital goods in the nature of structure equipment and inventory

Q9. What is APS?

Ans. It is the ratio of total saving to total income APS = S/Y

Q9. Define Multiplier.

Ans. It is the ratio of a change in income to a change in investment. K= $\Delta Y/\Delta I$

Q10. Define Autonomous investment.
Ans. It is the investment made irrespective the level of income. It remains same at all levels of income.
Q11. Define autonomous consumption.
Ans. It refers to the minimum level of consumption even when income is zero.

Q12. What is relationship between APC and APS?
Ans. APC + APS= 1

Q13. Define excess demand.
Ans. It refers to a situation where aggregate demand is more than aggregate supply at full employment level.

Q14. What is deficient demand?
Ans. It refers to a situation where aggregate demand is less than aggregate supply at full employment level.

Q15. If planned savings are greater than planned investments what will be its effect on inventories?
Ans. Inventories will rise

Q16. If MPC = 0.85 find MPS.

Ans. 0.15

Q17. What is the relation between MPC and MPS or APC and APS?

Ans. MPC + MPS = 1 and APC + APS = 1

Q18.What is the relation between multiplier and MPC? (or MPS)

Ans. Positive with MPC (K = 1/1-MPC) or negative with MPS (K = 1/MPS)

Q19. What is meant by investment?
Ans. Investment means increase in the stock of capital.

Q20.Give the equation saving function.
Ans. S=-C + (1-c) Y

Q21. Define voluntary unemployment.
Ans. A situation in which a person is not willing to work on existing wage rate is called voluntary unemployment.

Q22.What is the relation between multiplier and MPC? (or MPS)

Ans. Positive with MPC (K = 1/1-MPC) or negative with MPS (K = 1/MPS)

Q23.If MPC = 0.80 find the value of multiplier.

Ans.

K = 1/1-MPC

K= 1/1-0.8

K = 1/0.2

K = 5

SHORT QUESTION ANSWERS(3/4 MARKS)

Q1. Explain the distinction between voluntary and involuntary unemployment.

Ans. (1) Voluntary unemployment is a situation in which a worker is not willing to work at the current rate of wages.

On the other hand, involuntary unemployment is a situation in which a worker is willing to work at current rate of wages but does not get work.

(2) Voluntary unemployment is not considered in the estimation of total unemployment in a country. While involuntary unemployment is considered in the estimation of total unemployment in the economy.

Q2. What is inflationary gap? What is its impact on output and prices?

Ans. Inflationary gap is the excess of AD over and above its level required to maintain full employment equilibrium in the economy, Inflationary gap generates pressure on the existing flow of goods and services at the level of full employment. Accordingly, prices tend to rise. The output will not increase.

Q3. Define Aggregate demand. State its components.

Ans. Aggregate demand is the total demand for goods and services in the economy. Aggregate demand in fact represents the total expenditure of goods and services in an economy.
There are four components of aggregate demand (AD):
(i)Consumption (ii) investment (ii) government expenditure (iv)net export (X-M)
AD=C+I+G+(X-M)

Q4. Explain consumption function with schedule.

Ans. It shows the relationship between consumption and income. *C = f(Y)*
i) At 0 level of income= minimum level of
Consumption (autonomous consumption)
ii) As Y rises C also rises , but rate of rise of C > Y

INCOME	***CONSUMPTION (Rs. crores)***

0	*50*
100	*100*
200	*150*
300	*200*
400	*250*
500	*300*

Q5 . Explain saving function with saving schedule.

Ans. The relationship between saving and income is called saving function. S = f(Y)

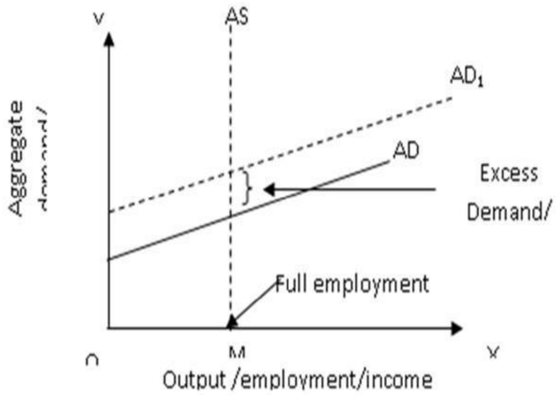
Income	*Saving(Rs. Crores)*
0	*-50*
100	*0*
200	*50*
300	*100*
400	*150*
500	*200*

Q6. What is meant by investment multiplier? Explain the relation between MPC and investment multiplier?

Ans. Investment multiplier is defined as the ratio of change in income due to change in investment
Multiplier (k) =ΔY/ΔI
Relationship between multiplier and MPC: the value of the multiplier varies directly with MPC
Higher the MPC, the higher will be the multiplier and vice versa. The relationship expressed
as k=1/1-MPC
FOR example, if *MPC =. 5 , K= 2.*
If MPC= .8, K=5

Q7. Explain the concept of inflationary gap. Explain by diagram

Ans. Inflationary gap may be defined as an excess of aggregate demand over aggregate supply at the full employment level. The inflationary gap results in the rise in general price level which is called inflation. The amount by which aggregate demand exceeds the level of aggregate production corresponding to full employment level of national income is known as inflationary gap.



Q8. What is fiscal policy? How is it used to correct Excess demand suggesting two measures?

Ans. Fiscal policy refers to the expenditure and taxation policy of the government. To correct excess demand two fiscal measures can be taken:

1. **Reducing Govt Expenditure: There is a lot of non-essential and non-productive expenditure which can be reduced to control excess demand. Govt can cut down its subsidies as on various items such as food, fertilizers, power supply export etc.**
2. **Increasing Taxes: when there is excess demand in in the economy 'Govt should map up more resources from the public by increasing imposing taxes**

Q9. Explain the meaning of deflationary gap.

Ans. Deflationary gap is the situation when aggregate demand is less than aggregate supply at full employment level .It is the difference between actual level of aggregate demand and the level of aggregate demand required to achieve the full employment equilibrium.

Q10. Explain the role of CRR and Repo Rate to correct deficient demand.

Ans. Cash reserve ratio refers to the minimum percentage of a bank's total deposit to keep with central bank. During deficient demand CRR is reduced which will increase the cash recourses of commercial bank and increasing credit availability in the economy.
Repo rate is the rate of interest at which central bank lends to commercial banks. During deficient demand Repo rate is reduced..

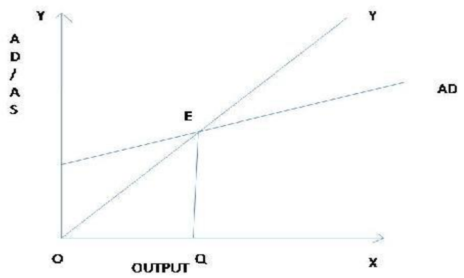
Q11. What is monetary policy? Suggest two monetary measures to control the situation of deficient demand.

Ans. Monetary policy is that policy of the Government which corrects the situations of excess and deficient demand by regulating interest rate and availability of credit in the economy.
Measure to control the situation of deficient Demand:
(i) Repo rate is lowered; following which market rate of interest is reduced.
(ii) CRR and SLR are lowered. This rises the capacity of the commercial bank to create credit.

Long Answer Questions
(6 Marks)

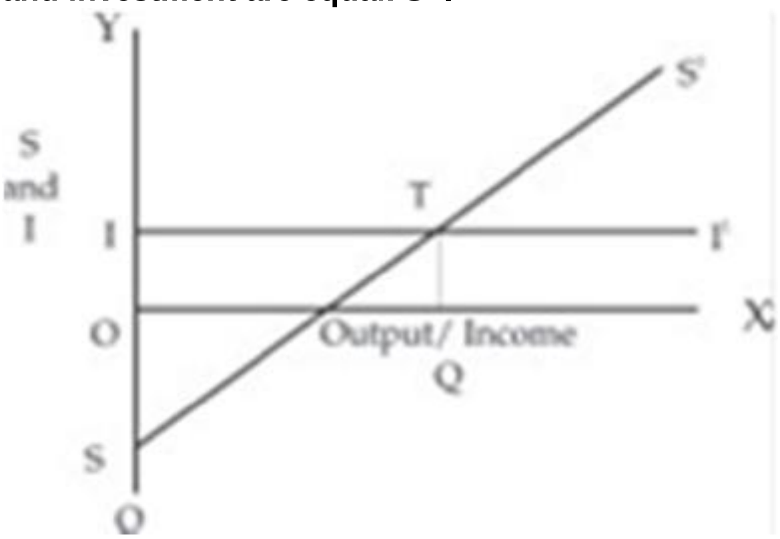
Q1. Explain the determination of equilibrium level of income by aggregate demand and aggregate supply approach or C+I approach.

Ans. According to Keynes, equilibrium level of income and output is determined at that point where Aggregate demand and Aggregate supply are equal to each other.
AD= It is the summation of consumption demand and investment demand. Or AD= C+I.
AS=It refers to the flow of goods and services in the economy in an accounting year



Q2. Explain the equilibrium level of income with the saving and investment curve.

Ans. The equilibrium level of income is determined at the point where savings and investment are equal. S=I



Q3.Explain the concept of deflationary gap. What is its impact on output, employment and price level in the economy?

Ans. It is a situation when resources are not fully utilized and there is excess capacity in the economy. The economy drifting towards a situation of deflation. Accordingly deficiency of AD (compared to its full employment level) is often described as a situation of deflationary Gap.

Impact:

(i) When AD fails to facilitate fuller utilization of factors and there is excess capacity with the producers, they tend to build up unwanted inventory stock.
(ii) Accumulation of inventory stock would force the producers to plan lesser production and employment.

Q4.Explain the concept of inflationary gap. What is its impact on output, employment and price level in the economy?

Ans. In a situation of excess demand, the level of output does not rise. Infact it cannot raise because factors are already full employed. Output level remain constant corresponding to the full employment level. Only price tend to rise.

IMPACT:
(i) When AD increases beyond its full employment level, output remains constant. But, the pressure on demand on the existing supply starts mounting up.
(ii) Mounting pressure on demand on the existing output causes a rise in the prices.

(iii) Excess demand also generates pressure of demand on existing resources, further it causes rise in the general price level.

Q5. The consumption function for an economy is C= 100+ 0.5 Y. Determine the level of income

Ans. when APC=1.
Given APC=1=C/Y means C=Y or break even point
Putting C = Y in the consumption function,
100 + 0.5 Y = Y
Y – 0.5 Y = 100
0.5 Y = 100
Y= 200

Q6. If in an economy C = 200 + 0.9 Y and I = 3000 . Calculate i)equilibrium level of national

Ans. income and ii)saving at equilibrium level of national income.
i) At equilibrium level, AS = AD
Y = C + I
Y = 200 + 0.9 Y + 3000
Y – 0.9 Y= 3200
0.1 Y=3200

Y = 3200/0.1= 32000
iii) C = 200 + 0.9 Y
By putting value of Y, C= 29000
S = Y- C
S= 32000- 29000= 3000

Q6. Explain the relationship between investment multiplier and marginal propensity to consume.

Ans. The value of multiplier is determined by the MPC .Higher the MPC, greater the size of multiplier and vice versa. There is a direct relationship between multiplier and MPC
Symbolically, k = 1/1-MPC
According to the Keynes, the value of MPC is always greater than zero but less than one accordingly, the value of multiplier would be greater than one but less than infinity. The value of multiplier thus varies from unity to infinity.
Since we know that
MPC+MPS = 1
So we can write the investment multiplier.
K= 1/MPS
So when MPC is equal to 1
K = 1/1-MPC = 1/1-1 =1/0 =∞
It is clear that value of MPC is equal to 1 or MPS is zero then multiplier value will be ∞
K = 1/MPS =1/1 =1
K=1

UNIT-8 GOVERNMENT BUDGET

Q1. Define a budget.

Ans. It is an annual statement of the estimated receipts and expenditure of the government over the fiscal year.

Q2. When Budget is normally presented in the Parliament?
Ans. On 28^{th} February.

Q3. Name the two components of budget.
Ans. (1) Budget Receipts (2) Budget Expenditure.

Q4. What are the two divisions of budget?

Ans . a) Revenue Budge b) Capital Budget

Q5. What are the two budget receipts?

Ans. a) Revenue Receipts b) Capital Receipts

Q6. What are the two types of Revenue Receipts?

Ans. a)Tax revenue b)Non- Tax Revenue

Q7. Give two example of non-tax revenue.
Ans. (1) Dividend (2) Fees and fines (3) Gift and Grants (4) Profits and Dividends
(5) Interest (6) Escheats (7) Forfeitures

Q8. Give two example of direct tax.
Ans. (1) Income tax (2) Gift tax (3) Wealth Tax (4) Capital Gain (5) Interest Tax

Q9. Give two example of indirect tax.
Ans. (1) Sales tax (2) Custom duty (3) Service Tax (4) Entertainment Tax (5)Excise Duty

Q10. Give two examples of developmental expenditure.
Ans. (1) Expenditure incurred on education
(2) Expenditure incurred on industrial development.

Q11. Give two example of non-development expenditure.
Ans. (1) Expenditure on Defence.
(2) Expenditure on general administration.

Q12. What are the two different concepts of budget deficit?

Ans. **a)** Budget Deficit b) Revenue Deficit

c) Primary Deficit d) Fiscal Deficit

Q13. Define Capital receipts.

Ans. Capital Receipts refer to those receipts of the government which (i) tend to create a liability or (ii) Causes reduction in its assets.

Q14. Define revenue receipts.

Ans. A revenue receipts are those receipts which neither create a liability nor reduce assets of the government. eg: Tax and non-tax receipts.

Q15. Define revenue expenditure.

Ans. It does not result in creation of assets or reduction in liabilities eg. Payment of salaries.

Q16. Define Capital expenditure.

Ans. It refers to the expenditure which leads to creation of assets and reduction in liabilities eg. Expenditure incurred on construction of building, roads, bridges etc.

Q17. Define plan expenditure.

Ans. Plan expenditure refers to the estimated expenditure which is provided in the budget to be incurred during the year on implementing various projects and programs included in the plan.

Q18. What do you understand by non-plan expenditure?

Ans. Expenditure other than plan expenditure is treated as non-plan expenditure.

Q19. Define development expenditure.

Ans. It refers to expenditure on activities which are directly related to economic and social development of the Country.

Q20. Defline non-dévelopent expenditure.

Ans. It refers to expenditure incurred on essential general services of the government.

Q21. Give two sources of Capital receipts.

Ans. (1) Recovery of loans (2) Borrowings.

Q22. Give one objective of budget.

Q23. Give two example of revenue expenditure.

Ans. (1) Payment of Salaries (2) Interest payment

Q24. Give two example of Capital expenditure.

Ans. (1) Loan to public, (2) Acquiring land, building, machine and investment in shares etc.

Q25. Give one objective of budget.

Ans. To reduce inequalities of income and wealth.

Q26. Why is borrowings considered as Capital receipt?

Ans. It increases the liability of the government, so it is considered as Capital receipt.

Q27. Define tax.

Ans. Tax is legal compulsory payment imposed by the government on the people.

Q28. Define direct tax.

Ans. These taxes are those tax in which liability to pay and burden of tax falls on same person.

Q29. Define indirect tax.

Ans. Liability to pay and burden of indirect tax falls on different persons.

Q30. Why is tax not a Capital receipt?

Ans. Tax neither creates liability nor reduces assets, so it is not considered as capital receipt.

Q31. What is balanced budget?

Ans. A Government budget is said to be a balanced in which government receipts are shown equal to government expenditure

Q32. What is Surplus budget?

Ans. When government receipts are more than government expenditure in the budget, the budget is called a surplus budget.

Q33. What is deficit budget?

Ans. When government expenditure exceeds government receipts in the budget is said to be a deficit budget.

Q34. Give the formula to calculate 'Revenue Deficit'.

Ans. Revenue deficit = Total revenue expenditure – Total revenue receipts.

Q35. Give the formula to calculate 'Fiscal Deficit'.

Ans. Fiscal Deficit = Total budget expenditure = Total budget receipts net of borrowings.

Q36. Give the formula to calculate 'Primary Deficit'.

Ans. Primary deficit = Fiscal deficit – interest payment

3 or 4 mark Questions & answers

Q1. Explain the objectives of govt. budget.

Ans. 1) Reallocation of Resources: The govt. has to reallocate the resources to ensure social & economic objectives.

2) Redistributive Activities: The Government redistributes income & wealth to reduce inequalities.

3) Stabilizing Activities: The Government tries to prevent business fluctuations and maintain economic stability.

4) Managing of Public Enterprises: Government undertakes commercial activities through public enterprise.

Q2. Define Direct taxes & Indirect Taxes& give two examples each.

Ans. 1) Direct Tax: These are those taxes levied immediately on the property and income of persons and are directly paid by people to the government.

Examples: Income Tax, Wealth Tax.

2) Indirect Taxes: These are those taxes that levied on one person but are paid by another person.

Examples: Sales Tax, Custom Duties.

Q3. What are the non-tax receipts (revenue)?

Ans. Refers to the receipts of the government from all sources other than those of tax receipts.

a) Commercial Revenue: eg: Payments for postage, Railway services.

B) Interest and Dividends.

c) Administrative Revenue: Examples: Fees, Fines.

Q4. What are the three major ways of public expenditure?

Ans. a) Revenue Expenditure &Capital Expenditure.

b) Plan Expenditure & Non- Expenditure

c) Development & Non- Development Expenditure

Q5. What do you mean by Revenue Expenditure &Capital Expenditure?

Ans. a) Revenue Expenditure: It is the expenditure incurred for the normal running of government departments and provision of various services like interest payment, subsidies.

b) Capital Expenditure: It consists mainly of expenditure on acquisition of assets like land, building, machinery, equipment.

Q6. Define Balanced, surplus, & Deficit budget.

Ans. Balance Budget: It is one where the estimated revenue equals the estimated expenditure.

b) Surplus Budget: It is one where the estimated revenue is greater than the estimated expenditures.

c) Deficit Budget: It is one where the estimated revenue is less than the estimated expenditures.

Q7. What are the different concepts of budget deficit?

Ans. a) Budget Deficit: When budget expenditure is more than budget revenue.

Formula: Budget Deficit = Budget Expenditure = Budget Revenue)

a) **Fiscal Deficit:** refers to the excess of total expenditure over total receipts (excluding borrowings) during the fiscal year.

Formula: Fiscal Deficit = Budget Expenditure - Budget receipts (excluding borrowings)

c) Revenue Deficit: It is the excess of government revenue expenditures over revenue receipts.

Formula: Revenue deficit = Revenue Expenditure - Revenue Receipts.

d) Primary Deficit: refers to difference between fiscal deficit of the current year and interest payments on the previous borrowings.

Formula: Primary Deficit = Fiscal Deficit - Interest Payment.

Q8. Write any three objective of government Budget.

Ans. The objective that are pursued by the government through the budget are-

(i) To achieve economic growth.
(ii) To reduce in equalities in income and wealth.
(iii) To achieve economic stability.
(iv) Management of Public Enterprises
(v) Reallocation of Resources

Q9. Explain the basis of classifying government receipts into revenue receipts and capital receipts.

Ans.

	Revenue Receipts	**Capital Receipts**
1	Revenue Receipts do not create any liability.	Capital Receipts always create a liability.
2	Revenue Receipts do not reduce assets of the government.	Capital Receipts causes for reduction in the assets of the government.
3	Eg. Dividend, Tax and non tax revenue.	Eg. Borrowings, Disinvestment, Recovery of loans etc.

Q10. Distinguish between direct tax and indirect tax

Ans.

	Direct Tax	**Indirect Tax**
1	Liability to pay and burden of direct tax falls on same person.	Liability to pay and burden of direct tax falls on some other person.
2	Direct taxes are levied on individuals and companies.	Indirect taxes are levied on goods and services.
3	Levied on income and property of person.	Levied on goods and services on their sale, Production, import and export.
4	Direct taxes are generally progressive in nature.	Indirect taxes are generally proportional in nature.
5	Eg. Income tax, Corporate tax, Wealth Tax, Capital Gains etc.	Eg. Sales tax, Service Tax, Excise duty, Custom duty etc.

Q11. Distinguish between Revenue and Capital expenditure.

Ans.

	Revenue Expenditure	Capital Expenditure
1	It does not result in creation of assets	It result in creation of assets.
2	It does not reduce any liability.	It result in reduce in liability.
3	It is for day to day activity and recurring in nature.	It for long period and non-recurring in nature.
4	Eg. Expenditure on salaries of employees	Eg. Expenditure on acquisition of assets like land, building etc.

Q12. Write a note on plan and non-plan expenditure of the government with example.

OR

Distinguish Between Plan and Non- Plan Expenditure.

Ans:

	Plan Expenditure	Non- Plan Expenditure
1	Plan expenditure refers to the estimated expenditure which is provided in the budget to be incurred during the year on implementing various projects and programs included in the plan.	This refers to the estimated Expenditure provided in the budget for spending during the year on routine functioning of the government.
2	Such expenditure is incurred on financing the central plan relating to different sectors of the economy	There is no provision in the plan for such expenditure.
3	Plan expenditure is arises only when the plans for such an expenditure.	Non plan expenditure is must for every economy and the government can't escape from it.
4	Eg. Expenditure on agriculture and allied industries, energy, transport, general economic and social services.	eg:.Payment of interest, Expenditure on defence, subsidies, administrative services etc.

Q13. Distinguish between development and non-developmental Expenditure.

Ans.

	Development Expenditure	**Non-Developmental Expenditure**
1	It refers to expenditure on activities which are directly related to economic and social development of the country.	It refers to expenditure incurred on essential general services of the government.
2	It directly contributes to national Product.	2. It does not contribute directly to national product.
3	Example: expenditure on education, health etc.	Example: Expenditure on defence, subsidy on food etc.

Q14. Define revenue receipts. Write the groups in which they are classified.

Ans. Any receipts which do not either create a liability or lead to reduction in assets is called revenue receipts. Revenue receipts consist of –

(1) Tax Revenue and (2) Non-Tax Revenue.

6 marks Questions & answers

Q1. Explain the implications of revenue deficit.
Ans. IMPLICATIONS OF REVENUE DEFICIT

- It indicates the inability of the govt. to meet its regular and recurring expenditure in the proposed budget.
- It implies that govt. is dissaving, i.e., govt. is using up savings of other sector of the economy to finance its consumption expenditure.
- Revenue deficit either leads to an increase in liability in the form of borrowings or reduce the assets through disinvestment.
- Use of capital receipts for meeting the extra consumption expenditure leads to an inflationary situation in the economy.
- Higher borrowings increase the future burden in terms of loan amount and interest payments.
- A high revenue deficit gives a warning signal to the govt. to either curtail its expenditure or increase its revenue.

Measure to reduce Revenue deficit

- Govt. should take serious steps to reduce its expenditure and avoid unproductive or unnecessary expenditure.
- Increase revenue.

Q2. **Explain the implications of Fiscal deficit.**
Ans. IMPLICATIONS OF FISCAL DEFICIT

- **1. Debt Trap:** Fiscal deficit indicates the total borrowings requirement of the govt. Borrowings not only involve repayment of principal amount, but also require payment of interest, Interest payment increase the revenue expenditure, which leads to revenue deficit. It creates a vicious circle of fiscal deficit and revenue deficit, where in govt. takes loan to repay the earlier loans. As a result is caught in a debt trap.
- II. **Inflation: Govt.** mainly borrows from RBI to meet its fiscal deficit. RBI prints new currency to meet the deficit requirement. It increases the money supply and creates inflationary pressure.
- Govt. borrows from ROW, which raises its dependency on other countries.
- Borrowings increase the financial burden for future generation.

VALUE BASED QUETIONS

Ques1. In India a majority of population is lying below poverty line due to inequality of 'Income and Wealth' . How can budget be helpful in solving this problem?

Ans - In Indian budget progressive tax system can be a good measure to remove the inequality of 'income and wealth' and govt. should provide social facilities like education, health & food grain to the poor at subsidized rate. Value- Problem Solving

Ques2. There has been consistent rise in prices of fruits and vegetables in Delhi for sometimes. Which measures of budget will you support to reduce the prices of these commodities?

Ans - Prices of fruits and vegetables can be reduced by providing subsidies to the producer of fruits & Vegetables and govt. should also provide fruits and vegetables at subsidized rates to the consumers through public distribution system. Value- Problem Solving

Ques3. Budget deficit creates disequilibrium in every economy but in developing countries like India, why does Govt. depend on it?

Ans - Per capita income in developing countries like India is comparatively low so the tax receipts of the Govt are not sufficient, but on the other hand govt. has to incur heavy public expenditure for the development of economy so Govt. is compelled on budget deficit. Value- Economic Awareness

Ques4. Classify following items into Revenue Expenditure and capital expenditure. Give reason for your answer.

1. **Free Supply of Stationary to the students by the Govt.**
2. **Economic assistance given according to Ladli Scheme.**
3. **Expenditure on the construction of computer lab in school.**
4. **Expenditure on Mid Day Meal given to students by the Govt.**

Ans - 1, 2 &4 are revenue expenditure because it neither creates assets nor cause reduction in assets. 3 is capital expenditure because it increase assets of the Govt. Value - Analytic

UNIT – 9 FOREIGN EXCHANGE AND BALANCE OF PAYMENTS

ONE MARK QUESTIONS:

Q1: What do you mean by foreign exchange market?

Ans: The foreign exchange market is the market where international currencies are traded for one another.

Q2. What is meant by Foreign Exchange Rate?

Ans. Foreign Exchange Rate is the price of one currency in terms of another. It is the rate at which exports and an import of a nation is valued at a given point of time.

Q3. What is meant by balance payment?

Ans. The balance of payment of a country is a systematic record of all economic transactions between the residents of the reporting country and the residents of foreign countries during a given period of time.

Q4. Give two examples of invisible items of balance of payments.

Ans. The two examples of invisible items of balance of payments are:-

1) **Services like shipping, insurance banking**
2) **Expenditure by tourists.**

Q5. What is meant by balance of trade?

Ans. Balance of trade takes into account only those transactions arising out of the experts and imports of goods(the visible items).It does not consider the exchange of services.

Q6: What do you mean by disequilibrium in BOP?

Ans: Disequilibrium in BOP is means either there is surplus or deficit in Balance of payment account.

Q7: Why is foreign exchange demanded?

Ans. Foreign exchange is demanded for the following purposes:

a) Payment of international loans.

b) Gifts and grants to rest of the world.

c) Investment in rest of the world.

Q8: What determines the flow of foreign exchange into the country?

Ans: Following factors contribute to the flow of foreign exchange into the country:

a) Purchase of domestic goods by the foreigners.

b) Speculative purchase of foreign exchange. c) When foreign tourists come to India.

Q9: What is meant by appreciation of currencies?

Ans: Appreciation of a currency occurs when its exchange value in relation to currencies of other country increases.

Q10: what is equilibrium rate of exchange?

Ans: Equilibrium exchange rate occur when supply of and demand for foreign exchange are equal to each other.

Q11: The balance of trade shows a deficit of Rs. 600 crore, the value of export is Rs. 1000 crore. What is value of import?

Ans: Balance of trade = Exports of goods – imports of goods Imports of goods = Export of goods – BOP = 1000-(-600) =1600.

Q12: Name three such items which are not included in Balance of trade?

Ans: Three items which are not included in BOT:

a) Export and import of services such as shipping, insurance and banking.

b) Interest and dividend funds.

c) Expenditure by the tourists.

Q13: Name the two accounts of balance of payment.

Ans. (1) Current account (2) Capital account

Q14: What are the components of Capital Account?

Ans: Components of Capital Account:

1) Foreign investment: i) FDI (Foreign Direct Investment) ii) Portfolio investment

2) Loans/borrowing: i) Commercial borrowing ii) Borrowings as external assistance. Ans

Q15: What type of transactions is recorded in the capital account of balance of payments?

Ans. **The capital account records all international transactions that involve a resident of the domestic country changing his assets with foreign resident or his liabilities to a foreign resident.**

Q16: what is the difference between Balance of Payment and Balance of Trade?

Ans : BOT is different from BOP. BOT records visible items only. BOP records both visible and invisible items, besides capital transfers.

Q17: What type of activities is recorded in the current account of balance of payment?

Ans. **The current account records imports and exports of goods and services and unilateral transfers.**

Q18:What type of transactions is recorded in the capital account of balance of payments?

Ans. **The capital account records all international transactions that involve a resident of the domestic country changing his assets with foreign resident or his liabilities to a foreign resident.**

Q19:What are unilateral transfers or unrequited transfers?

Ans. **Unilateral transfers are receipts which residents of a country make without getting anything in return eg. Gifts etc. The net balance of visible trade, invisible trade and of unilateral transfers is the balance on current account.**

Q20:Are exports and imports recorded as positive or negative items in exchange?

Ans. **Exports cause an inflow of foreign exchange into the country so they are entered as positive items. Imports cause an outflow, so they are entered as a negative item.**

Q21: Give an example of private unrequited transfers.

Ans. **Domestic residents receive gifts from or make to foreign residents. For eg. An Indian resident working in Dubai sending money to their relative in India.**

Q22: Give an example of official unrequited transfers.

Ans. **Receipt of or giving of foreign aid from development countries to developing countries.**

Q23: What is meant by 'Portfolio Investment' in the capital account transactions?

Ans. Portfolio Investment is the acquisition of an asset that does not give the purchaser control over the asset. For eg.Investment in the purchase of shares in a foreign company or of bonds issued by a foreign govt.

Q24: What is meant by 'Direct Investment' in the capital account transactions?

Ans. Direct investment is the act of purchasing an asset and at the same time acquiring control of it. For example, acquisition of a firm in one country by a firm in another country.

Q25. What is the shape of the demand curve of foreign exchange market?

Ans. The demand curve is downward sloping

Q26. What is the shape of the supply curve of foreign exchange?

Ans. The supply curve of foreign exchange is upward sloping.

Q27. What is meant by currency depreciation?

Ans. When there is an increase in the exchange rate, which means more rupees are required to buy one US dollar, we say that our currency is depreciating

Q27. Why was the gold standard system abandoned in the 1920s?

Ans. The gold standard system was abandoned, as it failed to automatically correct the disequilibrium in countries, balance of payments.

Q28. What is flexible exchange rate system?

Ans. In the flexible exchange rate system there is no intervention by the central bank. The exchange rate is determined by supply of and demand for foreign exchange

Q29. What is the managed floating system of exchange rate determination?

Ans. In this system the monetary authority can intervene in foreign exchange rate determination whenever it feels desirable.

Q30. What is dirty floating?

Ans. When a particular country manipulates its managed float system to the detriment of other countries, the behaviour is called as dirty float..

Q31. What is spot market in foreign exchange?

Ans. If the operation in the foreign exchange market is of daily nature, it is called current market or spot market.

Q32. Define forward market?

Ans. Market for foreign exchange for future delivery is known as the forward market

Q33. Define spot exchange rate?

Ans. It is the rate at which foreign currencies are available on the spot.

Short Answer Questions :-

Q1. Differentiate between balance of payment and balance of trade.

	Balance of Trade	Balance of Payments
Components	Balance of trade is a record of only visible items i.e. exports and imports of goods. Balance of trade is a narrower concept as it is only a part of the balance of payments account.	Balance of payments is a record of both visible items (goods) and invisible items (services) Balance of payments is a wider and more useful concept as it is a record of all transactions in foreign exchange including balance of trade
Status	Balance of trade can be in a deficit, surplus or balanced	Balance of payments must always balance.
Settlement	Unfavorable BOT can be met out with of favorable BOP	Unfavorable BOP can not be met out with of favorable BOT
Capital Transaction	BOT does not record ant transaction of capital nature.	BOP records all the transactions of capital nature.

Q2. Explain the components of capital account.

Ans. It records are international transactions that involve a resident of the domestic country changing his assets with a foreign resident or his liabilities to a foreign resident.

Various forms of capital account transactions :-

(1) Private Transactions :- There are transactions that effect the liabilities and assets of individuals.

(2) Official Transactions :- Transactions affecting assets and liabilities by the govt. and its agencies.

(3) Portfolio Investment (FII) :- It is the acquisition of an asset that does not give the purchaser control over the asset.

(4) Direct Investment (FDI) :- It is the act of purchasing an asset and at the same time acquiring control of it.

The net value of the balance of direct and portfolio investment is called the balanced on Capital Account.

Q3. Differentiate between Autonomous and accommodating items.

	Autonomous items	Accommodating items
1	Autonomous items refer to those international economic transactions that take place due to some economic motive such as profit maximization.	This refers to transactions that occur because of other activity in the BOP, such as government financing.
2	These transactions are independent of the state of the country's BOP.	These transactions are responsible for country's BOP.
3	These items are often called above the line items in the BOP.	These items are called below the line items.
4	Autonomous transactions take place on both current and capital accounts.	Accommodating transactions take place only on capital account.

Q4. Describe the cause for disequilibrium in the BOP.

Ans. The causes of disequilibrium in the BOP are:-

(1) Economic Factors: - Large scale development expenditure that may cause large imports.

- Cyclical fluctuations in general business activity such as recession or depression.
- High domestic prices may result in increase in imports.
- New sources of supply, new and better substitutes to existing products and changes in costs will bring about a change in trade flows and hence BOP over a period of time.

(2) Political Factors: - Political instability can cause large capital outflows and reduce the inflow of foreign capital.

(3) Social Factor: - Changes in tastes, preferences and fashion may affect imports and exports and hence the balance of trade.

Q4. Give two reasons for the people to acquire foreign exchange.

Ans. Two reasons for the people to acquire foreign exchange are:

(a) To purchase goods and services from the other countries.
(b) To purchase financial assets in a particular country.

Q1. How does import and export component affect the circular flow of income in a country?

Ans1. Export reflects expenditure on the domestic product by the rest of the world. It works as injection into the circular flow of income. It stimulates the flow of income by way of multiplier effect an import on the other hand is a withdrawal from the circular flow of income. It depresses the flow of income by way of negative multiplier effect.

Q2. How does balance of payment reflect supply, demand status of foreign exchange for a country?

Ans. Unfavourable BOP status of a country like India shows our greater financial obligations to rest of the world then our financial claims against rest of the world. It also reflects the situation of low forex reserves of the country together these facts imply that: (1) availability of forex reserve is low and (2) demand for forex reserve is high. This pushes up our demand for forex in the international market.

Q3 classify the following transactions in current account or capital account.

1 purchase of shares of ITC by Microsoft
2 borrowing from IMF
3 Repayment of loan by Indian government taken from Germany.
4 Remittance from abroad

Ans3. Current account - 4 capital account: 1, 2, 3

Q4 What are the effects of disequilibrium (deficit) in BOP?

Ans. 1.It reduces economic strength of the country as outflow is greater than inflow of foreign exchange

2. It hampers economic development of the country.

3. It reduces foreign exchange reserve of a country.

Q5. Balance of payment always balances. Does it means a situation of zero net financial obligation for a country?

Ans. It is only in the accounting sense that balance of payment always balances. From the practical point of view it should not be interpreted as a situation of zero net financial obligations for country. A negative balance on the current account is equated with positive balance in the capital account. But the positive balance in capital account may have been achieved through loans from rest of the world. All loans are the financial obligation to rest of world?

Q6. Differentiate between Current Account and Capital Account.

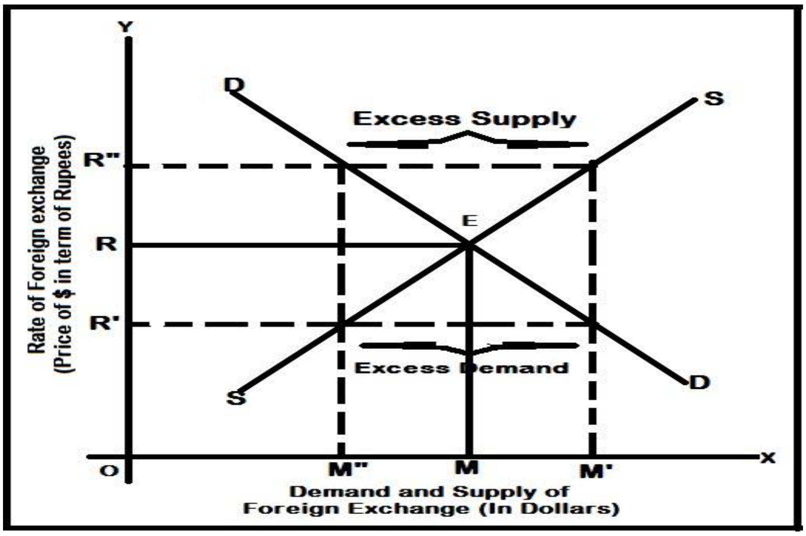
Ans.

Current Account	Capital Account.
Current Account transactions bring a change in the current level of a country's income.	Capital transactions bring about a change in the capital stock of a country.
It is flow concept as it includes all items of nature.	It is a stock concepts as it includes all items expressing changes in stock.
Current Account = Visible trade + Invisible trade + Unilateral transfers+ Income Receipts and payments.	Capital Account = Borrowing and landings to and from abroad + Investment to and from abroad + Change in Foreign Exchange Reserves.

Q7. "Equilibrium rate of exchange is determined when the demand for foreign exchange is equal to its supply." Explain this statement.

Ans. The Equilibrium rate is determined at a level where demand for foreign exchange is equal to the supply of foreign exchange.

In this diagram, demand and supply curve intersect each other at point 'E'. The Equilibrium exchange rate is determined at OR and equilibrium quantity is determined at OM.



- IF exchange rate rises to OR", than demand for foreign exchange will fall to OM" and supply will rises to OM'. It will be a situation of excess supply. As a result, exchange rate will fall till it again reaches the equilibrium level of OR.
- IF exchange rate falls to OR', demand will rises to OM' and supply will fall to OM". It will be a case of excess demand. It will push up the exchange rate till it reaches OR.