SUGGESTED SOLUTION

CA FOUNDATION

SUBJECT- ECONOMICS

Test Code – CFN 9268

BRANCH - () (Date :)

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1. According to point /geometric method, the formula to calculate price elasticity is lower segment of the demand curve from a given point divided by upper segment. So on a straight line demand curve touching both the axes, the price elasticity of demand at the mid – point would be 1.

[Ans.: B]

2. Increase and decrease in the supply of books is due to change in non – price factors. The supply of books will decrease if there is a decrease in the number of book publishers or an increase in the price of paper used (reducing profits) or an increase in the future expected price of the book.

[Ans.: B]

3. Economics has been defined as science of scarcity or choice – making. This is based on the fundamental facts that – human wants are unlimited; resource to satisfy our wants are scarce and limited resources have alternatives uses & knowledge of economic science helps us in addressing the problem of scarcity by either increasing the quantity of resource or by ensuring the optimum use of given resources.

[Ans.: A]

4. Demand is said to be elastic if proportionate change in demand for a product is more than proportionate change in its price. In case of Pepsi demand is elastic as its substitutes (Coke product & other soft drinks) are available. If there would have been no substitute then the demand would be perfectly inelastic.

[Ans.: C]

5. Rightward shift of the supply curve implies that more is being supplied at the same price. This can happen if technology improves so that the cost of production decreases & profit margin increases. On the other hand, if excise duty increases or if factors of production become costly, profit margin declines & supply decrease shifting supply curve to the left.

[Ans.: A]

6. Positive economic statements describe the events as they are. These statements are based on facts observations. On the contrary normative economic statements are prescriptive. They are in the nature of suggesting how events are expected to happen. These statements are in the nature of 'should be/ ought to be.'
   Here (A), (B) & (D) are positive economic statements.

[Ans.: C]

7. Business economics is basically applied microeconomics. It is a branch of economics which guides managers in taking decisions. It is more normative in nature and is multidisciplinary as it borrows tools from various disciplines to enrich the subject & make it relevant for appropriate decision – making. It avoids unnecessary abstractions present in pure economic theory.

[Ans.: D]

8. Consumer's budget line shows all possible combinations of two commodities that a consumer can purchase, given their prices. The slope of budget line is negative because increase in the quantity of one commodity would imply decrease in the quantity of the other commodity. The slope is constant because it is assumed that prices of two commodities do not change (slope of budget line is the ratio of two prices.)

[Ans.: C]

9. Income effect is change in quantity demanded of the commodity due to change in real income (purchasing power) of consumer as a result of change in price.
   In case of normal goods income effect is positive and in case of inferior goods it is negative which means that if price of inferior goods decreases less of it would be purchased on account of income effect.

[Ans.: A]

10. Ends are the same as goals which in case of defining economics refer to human wants.
Means are the same as resource (Physical and monetary) which are required to satisfy human wants/ends.

[Ans.: A]

11. Formula to calculate cross price elasticity of demand between two goods x & y is,

$e_c = \frac{\Delta D_x}{\Delta P_y} \cdot \frac{P_y}{D_x}$

Here if we assume x $\rightarrow$ ball – point pen and
y $\rightarrow$ gel pen then

$\Delta D_x = 500 - 400 = 100$ units

$\Delta P_y = 12 - 10 =$ Rs. 2

$P_y =$ Rs. 10 & $D_x = 400$

$\therefore e_c = \frac{100}{2} \times \frac{10}{400} = \frac{1000}{800} = \frac{10}{8} = +1.25$

[Ans.: A]

12. Expansion and contraction of supply is the result of change in quantity supplied due to change in price. It is takes place on the supply curve or along the supply curve.

Increase and decrease in supply is the result of change in quantity supplied due to change in factors other than price. It is basically shown pictorially through shifts in supply curves.

[Ans.: B]

13. Microeconomics studies the behavior of individual economic agents (buyer/seller). Macroeconomics studies the behavior of aggregated economic variables. It is the study of economy as a whole. It studies issues of national importance – like GDP/ GNP, inflation, employment, etc. Studying the causes of failure of a company falls under microeconomics.

[Ans.: B]

14. Business economics is basically applied microeconomics. It is a branch of economics which guides managers in taking decisions. It is more normative in nature and is multidisciplinary as it borrows tools from various disciplines to enrich the subject & make it relevant for appropriate decision – making. It avoids unnecessary abstractions present in pure economic theory.

[Ans.: C]

15. Elasticity of supply refers to the responsiveness of quantity supplied of a commodity due to given change in its price. If elasticity of supply is zero, it means that despite a change in price, quantity supplied is not changing. This is shown graphically by a vertical supply curve.

[Ans.: D]

16. Cross elasticity of demand measures proportionate change in quantity demanded of a commodity due to a given change in price of its related good. If two goods are substitutes then cross elasticity will be positive. If two goods are complements then cross elasticity will be negative. Rye bread & wheat bread being substitutes, cross elasticity between them is positive.

[Ans.: A]

17. Purchasing power of money means the amount of goods and services that given sum of money can purchase.
    Purchasing power of money is inversely related to the price level. If price level increases purchasing power of money decreases and vice versa.

[Ans.: A]

18. Positive economic statements describe the events as they are. These statements are based on facts observations. On the contrary normative economic statements are prescriptive. They are in the nature of suggesting how events are expected to happen. These statements are in the nature of 'should be/ ought to be.'
    Here (A), (B) & (D) are positive economic statements.

[Ans.: A]

19. Economics is defined as science of scarcity. Every country faces this problem – satisfying unlimited wants with scarce resources having alternative uses.

    There was scarcity in the pre – independent agricultural India.

    If everybody is a rich person still there is a problem of scarcity in relative sense.

    Even if income were to be equally distributed among people the problem of scarcity is going to remain in relative sense.

[Ans.: D]

20. Consumer surplus is defined as the difference between the maximum amount a person is willing to pay for a good & its market price. In terms of diagram it is the area between the price line (AR) and the demand curve (MU curve).

[Ans.: C]

21. According to Arc method,

$$e_s = \frac{\Delta S}{\Delta P} \cdot \frac{(P_1+P_2)}{(S_1+S_2)}$$

Here Δ S = 300 – 150 = 150 units

Δ P = 25 – 15 = Rs. 10

$P_1 + P_2$ = 25 + 15 = Rs. 40

$S_1 + S_2$ = 300 + 150 = 450

$$\therefore\ e_s = \frac{150}{10} \times \frac{(40)}{(450)} = \frac{60}{45} = +\,1.33$$

[Ans: B]

22. Economics is defined as science of scarcity or choice – making. This definition is premised on the facts that human wants are unlimited but the resources to satisfy those wants are limited and these limited resources have alternative uses. All countries face the problem of scarcity to lesser or greater degree. In this context the fundamental / basic/ central problem of economics is to allocate scarce resource in such a manner that society's unlimited wants can be satisfied in the best possible manner.

[Ans.: D]

23. Basically goods are of two types – durable & non – durable.

Non – durable goods are those which can be used once only. Durable goods can be used over a period of time.

Examples of consumer durables are TV, furniture, car, etc. There are two components of total demand for such goods – new demand (first time demand) and replacement demand.

[Ans.: C]

24. The formula to calculate coefficient of price elasticity is,

$e_p = \frac{\Delta D}{\Delta P} \cdot \frac{P_1}{D_1}$

Here Δ D = 15 – 10 = 5

ΔP = 4 – 6 = (-) 2

P_1 = 6; D_1 = 10

$\therefore$ $e_p = -\frac{5}{2} \times \frac{6}{10} = \frac{-30}{20} = -1.5$

[Ans.: C]

25. According to total outlay method, change in price and change in total revenue are directly related (increase in price resulting in increase in total revenue) if demand is inelastic (percentage change in quantity demanded less than percentage change in price).

[Ans.: A]

26. Economists use economic indicators to forecast trends in business activities. This information is then used to forecast demand prospects of a product. For this purpose, an index of relevant economic indicators is constructed. Movements in these indicators are used as basis forecasting the likely economic environment in the near future. There are 3 types of indicators – leading, coincident & lagging.

[Ans.: B]

27. Positive economic statements describe the events as they are. These statements are based on facts observations. On the contrary normative economic statements are prescriptive. They are in the nature of suggesting how events are expected to happen. These statements are in the nature of 'should be/ ought to be.'
Here (A), (B) & (D) are positive economic statements.

[Ans.: C]

28. Demand determinant are various factors affecting demand for a commodity. Some such factors are price of the commodity, price of related goods(substitutes/ complementary goods), income of the consumer & tastes & preferences of the consumers.

[Ans.: B]

29. Equilibrium in this context is defined as a situation in which demand for a commodity equals its supply.

If market of computers is not in equilibrium then it would it mean either of the following –
(i) if demand is more than supply, price will increase

(ii) if demand is less than supply, price will decrease.

In absences of detailed information about demand and supply imbalance, one cannot tell about the direction of change in price.

[Ans: C]

30. Basically to address the problem of scarcity of resources, three economic, systems exist – capitalism, socialism & mixed economy. These systems differ on the basis of how economy is managed. Mixed economy is a system where public & private sectors coexist. In such an economy the most important decisions affecting welfare of the masses are taken by the government & the vest are taken by the private sector.

[Ans.: B]

31. Microeconomics is the study of behavior of individual economic agents (buyer /seller). Central theme of microeconomic analysis is determination of prices – of goods, services & factors of production. So it is also known as value/ price theory.
Issues like economic growth, inflation & employment fall in the domain of macroeconomics.

[Ans.: D]

32. Market system or capitalism is one of the economic systems designed to address fundamental economic problems of what to produce, how to product & for whom to produce. In such a system all these decisions are taken by the market or private sector. Government interference in the functioning of the economy is the least. The biggest advantage of such a system is fast growth. But the biggest limitation of this system is highly unequal distribution of income & wealth between the rich & the poor.

[Ans.: A]

33. It is clearly given that supply and demand for strawberries will increase but it has not been mentioned which would increase more or less than the other. So we can certainly conclude that the quantity of strawberries bought and sold increases but the price may rise or fall or may even not change.

[Ans.: A]

34. Modern economics is divided into two branches – microeconomics & macroeconomics.
Microeconomic studies the behavior of individual economic agents (buyer or seller / firm). Applied microeconomics is known as business economics.

Macroeconomics studies the behavior of aggregated economic variables (like national income, employment etc.)
Behavioral economics is the study of psychology as it relates to the economic decision making processes of individuals and institutions.

[Ans.: A]

35. The formula to calculate income elasticity of demand using are elasticity method is

Using are elasticity method is

$Y_e = \frac{\Delta D}{\Delta y} \cdot \frac{(y_1+y_2)}{(D_1+D_2)}$

Here : - D_1 = 25; D_2 = 30; $\therefore$ Δ D= 30 – 25 = 5

Y_1 = 30,000; y_2 = 36,000; $\therefore$ Δy = 36000 – 30,000 = 6,000

Now $Y_e = \frac{5}{6000} \times \frac{(30{,}000+36{,}000)}{(30+25)} = \frac{5}{6000} \times \frac{66{,}000}{55}$

$= \frac{330}{300}$

$= 1$

[Ans.: B]

36. In a mixed economic system prices of most essential goods are determined by the government to protect economic welfare of the poorest of the poor. At the same time prices of normal or non – essential goods are allowed to be determined by the market forces of demand & supply. As two methods of price determination exist simultaneously it is known as dual system of pricing.

[Ans.: C]

37. Law of diminishing marginal utility relates extra satisfaction derived by consuming additional units of the same commodity continuously. It states that with each additional unit of commodity consumed, marginal utility keeps declining as intensity of want decreases.

Law of demand relates change in quantity demanded due to change in price of commodity.

Law of supply relates change in quantity supplied due to change in price of commodity Law of diminishing marginal refunds explains short run output behavior.

[Ans.: C]

38. As income of consumer rises beyond a threshold a consumer eventually stops buying inferior goods. These are the goods which have negative income elasticity i.e. their demand and income are inversely related.
Goods with positive income elasticity are known as normal goods (necessities or luxuries).

[Ans.: B]

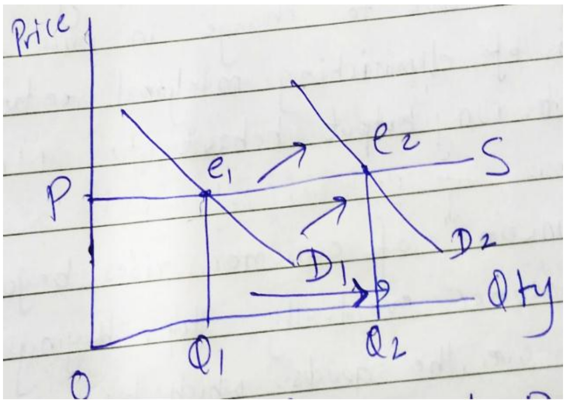
39. To address the fundamental problem of scarcity of resources each country can choose an economic system from among – capitalism, socialism & mixed economy.

These systems differ from each other in the way the economy is managed.

In socialism government plays an important role in deciding what to produce, how to produce & for whom to produce. Freedom given to private sector is the minimum. The biggest advantage of socialism is relative equality in distribution of income & wealth & complete absence of consumer & labor exploitation.

[Ans.: A]

40. Perfectly elastic supply means that any quantity of a commodity can be supplied at a given price. In such a situation if deemed increases there will be no change in price but equilibrium quantity will increase. The following figure make this more clear



Demand increase from D_1 to D_2 and equilibrium quantity from Q_1 to Q_2.

[Ans.: C]

41. Capital intensive technique is the one in which firms use more of capital (machines) in relation to labour. In a capital surplus economy it would make sense to go for capital intensive technique as due to its abundance, price of capital will be relatively less. So the cost will be low allowing for a higher profit margin. Using the same logic, labour surplus economies will adopt labour intensive technique.

[Ans.: B]

42. Inferior goods are those whose demand is inversely related with income of consumers. This means that as consumers become rich demand for such goods decreases and vice versa. Other way of defining inferior goods is through the concept of income elasticity. Due to inverse relationship between income & demand, their income elasticity is negative.

[Ans.: C]

43. Business economics is applied microeconomics. It is also known as managerial economics. It helps or guides managers in decision making process. It is basically prescriptive or normative & is inter – disciplinary in nature. It borrows insights from disciplines like management, finance, psychology, statistics, etc. Business economics also contains discussion on macro economic environment as a firm does not operate in a vacuum. Changes in macro variables like inflation, exchange rate, growth rate, etc. influence the functioning & profitability of firms.

[Ans.: C]

44. Average revenue curve is also known as demand curve because both of them show relationship between quantity demanded & price. Profit curve shows relationship between profit & quantity of output sold.
    Average cost curve shows relationship between AC and quantity of output produced.
    Indifference curve shows all those combinations of two goods which give equal level of satisfaction to the consumer.

[Ans.: B]

45. Socialism is an economic system in which all resources and factors of production are owned by the government and utilized in order to ensure maximum socio – economic welfare of people. Government plays an active role in such a system by way of administering planning and imposing rules and regulations. Market mechanism is not allowed to operate in socialism.

[Ans.: C]

46. Market system or capitalism is one of the economic systems designed to address fundamental economic problems of what to produce, how to product & for whom to produce. In such a system all these decisions are taken by the market or private sector. Government interference in the functioning of the economy is the least. The biggest advantage of such a system is fast growth. But the biggest limitation of this system is highly unequal distribution of income & wealth between the rich & the poor

[Ans.: C]

47. Long – term demand forecasting is forecasting demand for a product beyond the time period of 1 year. It is generally for 3 to 7 years. Such forecasting is useful in guiding firms in their strategic decisions like that of expansion, merger, takeover, etc.
Short – term demand forecasting which is done for a time period falling within a year is useful for operational/ tactical decisions.

[Ans.: B]

48. Income elasticity of demand measures responsiveness of demand for a commodity to a given change in income of consumers.

    If value of income elasticity of demand is positive but less than 1 then the good is a necessity.

    If value of income elasticity of demand is positive & greater than 1 then the good is a luxury.

[Ans.: C]

49. Production in future depends on capital formation or investment in present. Investment is nothing but increase in stock of real capital i.e. capital goods like machines, spare parts, components, etc. If more of consumer goods or public goods are produced today then production in future will suffer because the rate of capital formation has slowed down.

[Ans.: B]

50. Price elasticity of demand measures the responsiveness of demand for a commodity to a given change in its price.

    For luxury goods demand is elastic whereas for necessary goods demand is inelastic.

    Water is a necessity so its demand is inelastic i.e. proportionate change in demand is less than proportionate change in price whatever the increases in price people cannot cut down the consumption of water much.

[Ans. B]