



J.K. SHAH[®]
TEST SERIES
Evaluate Learn Succeed

SUGGESTED SOLUTION
INTERMEDIATE N'18EXAM
SUBJECT- F.M. AND ECO.
Test Code –PIN 5029
(Date :)

Head Office :Shraddha, 3rd Floor, Near Chinai College, Andheri (E), Mumbai – 69.

Tel : (022) 26836666

ANSWER-1**ANSWER-A****(5 MARKS)****(i) Cost of Equity Share Capital (K_e)**

$$K_e = \frac{D_0(1+g)}{P_0} + g = \frac{25\% \text{ of Rs. } 4(1+0.08)}{\text{Rs. } 40} + 0.08 = \frac{\text{Rs. } 1.08}{\text{Rs. } 40} + 0.08 = 0.107 \text{ or } 10.7\%$$

(ii) Cost of Debt (K_d)

$$K_d = \frac{\text{Interest}}{\text{Net Proceeds}} \times 100 \times (1-t)$$

Interest on first Rs. 2,00,000 @ 10% = 20,000

Interest on next Rs. 2,00,000 @ 15% = 30,000

$$K_d = \frac{50,000}{4,00,000} \times (1-0.3) = 0.875 \text{ or } 8.75\%$$

(iii) Weighted Average Cost of Capital (WACC)

Source of capital	Amount (Rs.)	Weights	Cost of Capital (%)	WACC (%)
Equity shares	6,00,000	0.60	10.70	6.42
Debt	4,00,000	0.40	8.75	3.50
Total	10,00,000	1.00		9.92

ANSWER-B**(5 MARKS)****CASH BUDGET FOR THE PERIOD JANUARY-MARCH**

	January	February	March
Opening Cash	Rs. 22,000	Rs. 35,000	Rs. 48,000
Cash Inflows :			
Cash sales	20,000	20,000	24,000
Debtors collected	80,000	80,000	80,000
Sale of machine	—	—	5,000
Total Cash (A)	1,22,000	1,35,000	1,57,000
Cash Outflows:			
Cash Purchases	2,000	2,000	2,000
Payment to creditors	40,000	40,000	40,000
Wages	15,000	15,000	15,000
Manufacturing expenses	20,000	20,000	20,000
General selling expenses	10,000	10,000	10,000
Purchase of machine	—	—	50,000
Total Outflows (B)	87,000	87,000	1,37,000
Cash balance (A-B)	35,000	48,000	20,000

ANSWER-C**(5 MARKS)****EVALUATION OF PROPOSALS**

	Present Plan (20,000 units)	Proposed Plan (22,000 units)
Sales	Rs.20,00,000	Rs.22,00,000
-Variable costs (Rs. 88 per unit)	17,60,000	19,36,000
-Fixed costs (20,000 units X Rs. 4)	80,000	80,000
Net Profit	1,60,000	1,84,000
Investment cost	27,600	50,400
Income	1,32,400	1,33,600

The firm should relax its credit policy as it increases the profit by Rs. 1,200.

Working Notes:

The investment costs have been calculated as follows :

	Present Plan	Proposed Plan
O' of sales (Variable + Fixed cost)	Rs.18,40,000	Rs.20,16,000
Average daily sale (360 days a year)	5,111	5,600
Credit period	36 days	60 days
Therefore, average debtors	1,84,000	3,36,000
Interest @15%	27,600	50,400

ANSWER-D**(5 MARKS)**

Paid-up equity Capital = Rs.40,00,000

Earnings of the year = Rs.4,00,000

Dividend Paid = Rs.3,20,000

P/E Ratio = 12.5

No. of Shares = 40,000

EPS or r = Rs. 4,00,000/40,000 = Rs. 10

Dividend per share (DPS) = Rs. 3,20,000/40,000 = Rs. 8

Walter's Model:

$$P = \frac{D + r/K_e (E - D)}{K_e}$$

If DPS = Rs. 8, then

$$O = \frac{8 + 0.10 / 0.08(10 - 8)}{0.08}$$

= Rs. 131.25

To get optimal, the DPS = 0

$$O = \frac{0 + 0.10 / 0.08(10 - 0)}{0.08}$$

= Rs. 156.26

So the value of share is optimal if dividend is nil.

ANSWER-2

Working Notes:

$$\text{Depreciation on Machine X} = \frac{1,50,000}{5} = \text{Rs. } 30,000$$

$$\text{Depreciation on Machine Y} = \frac{2,40,000}{6} = \text{Rs. } 40,000$$

Particulars	Machine X (Rs.)	Machine Y (Rs.)
Annual Savings:		
Wages	90,000	1,20,000
Scrap	10,000	15,000
Total Savings (A)	1,00,000	1,35,000
Annual Estimated Cash Cost :		
Indirect Material	6,000	8,000
Supervision	12,000	16,000
Maintenance	7,000	11,000
Total Cash Cost (B)	25,000	35,000
Annual Cash Savings (A-B)	75,000	1,00,000
Less : Depreciation	30,000	40,000
Annual Savings Before Tax	45,000	60,000
Less : Tax @ 30%	13,500	18,000
Annual Savings/Profit (After Tax)	31,500	42,000
Add : Depreciation	30,000	40,000
Annual Cash Inflows	61,500	82,000

(5 MARKS)

Evaluation of Alternatives**(5 MARKS)****(i) Average Rate of Return Method (ARR)**

$$\text{ARR} = \frac{\text{Average Annual Net Savings}}{\text{Average Investment}}$$

$$\text{Machine X} = \frac{31,500}{75,000} \times 100 = 42\%$$

$$\text{Machine Y} = \frac{42,000}{1,20,000} \times 100 = 35\%$$

Decision : Machine X is better.

[Note: ARR can be computed alternatively taking initial investment as the basis for computation (ARR = Average Annual Net Income/Initial Investment). The value of ARR for Machines X and Y would then change accordingly as 21% and 17.5% respectively]

(ii) Present Value Index Method

Present Value of Cash Inflow = Annual Cash Inflow x P.V. Factor @ 10%

$$\begin{aligned} \text{Machine X} &= 61,500 \times 3.79 \\ &= \text{Rs. } 2,33,085 \end{aligned}$$

$$\begin{aligned} \text{Machine Y} &= 82,000 \times 4.354 \\ &= \text{Rs. } 3,57,028 \end{aligned}$$

$$\text{P.V. Index} = \frac{\text{Present Value}}{\text{Investment}}$$

$$\text{Machine X} = \frac{2,33,085}{1,50,000} = 1.5539$$

$$\text{Machine Y} = \frac{3,57,028}{2,40,000} = 1.4876$$

Decision : Machine X is better.**ANSWER-3****1. Project S (Rs. Lakhs)****(3 MARKS)**

NPV Estimate (N)	Probability (CP)	Expected NPV ,	Deviation from Expected NPV (D)	Square of Deviation [D ²]	Variance [P x D ²]
(1)	(2)	(3) = (1) x (2)	(4) = (1) - Σ (3)	(5)	(6) = (2) x (5)
3	0.1	0.3	(6.0)	36.0	3.6
6	0.4	2.4	(3.0)	9.0	3.6
12	0.4	4.8	3.0	9.0	3.6
15	0.1	1.5	6.0	36.0	3.6

Expected NPV	9.0				14.4
--------------	-----	--	--	--	------

2. Project T (Rs. Lakhs)

(3 MARKS)

NPV Estimate (N)	Probability(P)	Expected NPV	Deviation from Expected NPV (D)	Square of Deviation [D ²]	Variance [P x D ²]
(1)	(2)	(3) = (1) x (2)	(4) = (1) — 2(3)	(5)	(6) = (2)x(5)
5	0.2	1.0	(9.1)	82.81	16.56
9	0.3	2.7	(5.1)	26.01	7.80
18	0.3	5.4	3.9	15.21	4.56
25	0.2	5.0	10.9	118.81	23.76
Expected NPV	14.1			52.68	

3. Evaluation

(4 MARKS)

Particulars	Project S	Project T
Variance [σ^2]	14.4	52.68
Standard Deviation [σ] [Risk Associated with the Project]	$\sqrt{14.4} = 3.79$	$\sqrt{52.68} = 7.26$
Expected NPV	9.0	14.10
Co-efficient of Variation = $\frac{\text{Standard Deviation}}{\text{Expected NPV}}$	$\frac{3.79}{9} = 0.42$	$\frac{7.26}{14.1} = 0.51$
Investment	30.0	50.0
Total Inflows = Investment + Expected NPV	30 + 9 = 39.0	50 + 14.1 = 64.1
Profitability Index = $\frac{\text{PV of Inflows}}{\text{PV of Outflows}}$	$\frac{39}{30} = 1.30$	$\frac{64.1}{50} = 1.28$

Observation: Project T is more risky than Project S, as the Standard Deviation and co-efficient of Variation is higher for Project T. Project S is also better in terms of return on investment, since the Profitability Index is higher.

ANSWER-4**Statement of Working Capital Requirement for PQ Ltd**

		Rs.	Rs.
A.	Current Assets		
(i)	Inventories :		
	Material (1 Month) $\left(\frac{\text{Rs.45,00,000}}{12 \text{ months}} \times 1 \text{ month} \right)$	3,75,000	
	Finished goods (1 Month) $\left(\frac{\text{Rs.1,35,00,000}}{12 \text{ months}} \times 1 \text{ month} \right)$	11,25,000	15,00,000
(ii)	Receivables (Debtors)		
	For Domestic Sales $\left(\frac{\text{Rs.90,00,000}}{12 \text{ months}} \times 1 \text{ month} \right)$	7,50,000	
	For Export Sales $\left(\frac{\text{Rs.45,00,000}}{12 \text{ months}} \times 3 \text{ months} \right)$	11,25,000	18,75,000
(iii)	Cash in hand and at bank (Rs.10,00,000 – Rs.5,00,000)		5,00,000
	Total Current Assets		38,75,000
B.	Current Liabilities :		
(i)	Payables (Creditors) for materials (2 months) $\left(\frac{\text{Rs.45,00,000}}{12 \text{ months}} \times 2 \text{ months} \right)$		7,50,000
(ii)	Outstanding wages (0.5 months) $\left(\frac{\text{Rs.36,00,000}}{12 \text{ months}} \times 0.5 \text{ month} \right)$		1,50,000
(iii)	Outstanding manufacturing expenses $\left(\frac{\text{Rs.54,00,000}}{12 \text{ months}} \times 1 \text{ month} \right)$		4,50,000
(iv)	Outstanding administrative expenses $\left(\frac{\text{Rs.12,00,000}}{12 \text{ months}} \times 1 \text{ month} \right)$		1,00,000
(v)	Income tax payable (Rs.15,00,000 ÷ 4)		3,75,000
	Total Current Liabilities		18,25,000
	Net Working Capital (A-B)		20,50,000
	Add : 15% contingency margin		3,07,500
	Total Working Capital required		23,57,500

(6 MARKS)

1. Calculation of Cost of Goods Sold and Cost of Sales

	Domestic (Rs.)	Export (Rs.)	Total (Rs.)
Sales	1,20,00,000	54,00,000	1,74,00,000
Less: Gross profit @ 25% on domestic sales and 16.67% on export sales (Working note-2)	(30,00,000)	(9,00,000)	(39,00,000)
Cost of Goods Sold/ Cash Cost of Sales	90,00,000	45,00,000	1,35,00,000

2. Calculation of gross profit on Export Sales:

Let domestic selling price is Rs.100. Gross profit is Rs.25, and then cost per unit is Rs.75

Export price is 10% less than the domestic price i.e. Rs.100 – (1- 0.1) = Rs.90

Now gross profit will be Rs.90 - Rs.75 = Rs.15

Therefore, Gross profit at domestic price will be $\frac{\text{Rs.15}}{\text{Rs.100}} \times 100 = 15\%$

Or, gross profit at export price will be $\frac{\text{Rs.15}}{\text{Rs.90}} \times 100 = 16.67\%$

Assumptions

- (i) It is assumed that administrative expenses relating to production activities.
- (ii) Value of opening and closing stocks are equal.
- (iii) Receivables are calculated based on cost of goods sold.

ANSWER-5**(a) Pattern of Raising Additional Finance**

Equity = 10,00,000 × 60/100 = Rs. 6,00,000

Debt = 10,00,000 × 40/100 = Rs. 4,00,000

Capital structure after Raising Additional Finance

Sources of fund	Amount (Rs.)
Shareholder's funds	
Equity capital (6,00,000 – 3,00,000)	3,00,000
Retained earnings	3,00,000

Debt at 10% p.a.	1,80,000
Debt at 16% p.a. (4,00,000 - 1,80,000)	2,20,000
Total funds	10,00,000

(4 MARKS)

(b) Post-tax Average Cost of Additional Debt

(2 MARKS)

$K_d = I(1 - t)$, where 'Kd' is cost of debt, 'I' is interest and 't' is tax.

On Rs. 1,80,000 = 10% (1 - 0.5) = 5% or 0.05

On Rs. 2,20,000 = 16% (1 - 0.5) = 8% or 0.08

Average Cost of Debt (Post tax) i.e.

$$K_d = \frac{1,80,000 \times 0.05 + 2,20,000 \times 0.08}{4,00,000} \times 100 = 6.65\% \text{ (approx)}$$

(c) Cost of Retained Earnings and Cost of Equity applying Dividend Growth Model

$$K_e = \frac{D_1}{P_0} \quad \text{or} \quad \frac{D_1(1+g)}{P_0} + g$$

$$\text{Then, } K_e = \frac{2 \times 1.1}{44} + 0.10 = \frac{22}{44} + 0.10 = 0.15 \text{ or } 15\%$$

(2 MARKS)

(d) Overall Weighted Average Cost of Capital (WACC) (After Tax)

Particulars	Amount (Rs.)	Weights	Cost of Capital	WACC
Equity (including retained earnings)	6,00,000	0.60	15%	9.00
Debt	4,00,000	0.40	6.65%	2.66
Total	10,00,000	1.00		11.66

(2 MARKS)

ANSWER-6

ANSWER-A

(4 MARKS)

American Depository Receipts (ADRs) :These are securities offered by non-US companies who want to list on any of the US exchange. Each ADR represents a certain number of a company's regular shares. ADRs allow US investors to buy shares of these companies without the costs of investing directly in a foreign stock exchange. ADRs are issued by an approved New York bank or trust company against the deposit of the original shares. These are deposited in a custodial account in the US. Such receipts have to be issued in accordance with the provisions stipulated by the Security Exchange Commission USA.

ADRs can be traded either by trading existing ADRs or purchasing the shares in the issuer's home market and having new ADRs created, based upon availability and market conditions. When trading in existing ADRs, the trade is executed on the secondary market on the New York Stock Exchange (NYSE) through Depository Trust Company (DTC) without involvement from foreign brokers or custodians.

Global Depository Receipts (GDRs): These are negotiable certificate held in the bank of one country representing a specific number of shares of a stock traded on the exchange of another country. These financial instruments are used by companies to raise capital in either dollars or Euros. These are mainly traded in European countries and particularly in London.

ANSWER-B

(a) **There are various sources available to meet short-term needs of finance. The different sources are discussed below:**

- (i) **Trade Credit:** It represents credit granted by suppliers of goods, etc., as an incident of sale. The usual duration of such credit is 15 to 90 days. It generates automatically in the course of business and is common to almost all business operations. It can be in the form of an 'open account' or 'bills payable'.
- (ii) **Accrued Expenses and Deferred Income:** Accrued expenses represent liabilities which a company has to pay for the services which it has already received like wages, taxes, interest and dividends.
- (iii) **Advances from Customers:** Manufacturers and contractors engaged in producing or constructing costly goods involving considerable length of manufacturing or construction time usually demand advance money from their customers at the time of accepting their orders for executing their contracts or supplying the goods. This is a cost free source of finance and really useful.
- (iv) **Commercial Paper:** A Commercial Paper is an unsecured money market instrument issued in the form of a promissory note.
- (v) **Treasury Bills:** Treasury bills are a class of Central Government Securities. Treasury bills, commonly referred to as T-Bills are issued by Government of India to meet short term borrowing requirements with maturities ranging between 14 to 364 days.
- (vi) **Certificates of Deposit (CD):** A certificate of deposit (CD) is basically a savings certificate with a fixed maturity date of not less than 15 days up to a maximum of one year.
- (vii) **Bank Advances:** Banks receive deposits from public for different periods at varying rates of interest. These funds are invested and lent in such a manner that when required, they may be called back. **(4 MARKS)**

ANSWER-C

Role of Finance Executive in modern World

Today, the role of Financial Executive, is no longer confined to accounting, financial reporting and risk management. Some of the key activities that highlight the changing role of a Finance Executive are as follows:-

- Budgeting
- Forecasting
- Managing M & As

- Profitability analysis relating to customers or products
- Pricing Analysis
- Decisions about outsourcing
- Overseeing the IT function.
- Overseeing the HR function.
- Strategic planning (sometimes overseeing this function).
- Regulatory compliance.
- Risk management.

(2 MARKS)

Answer : 7

(A) Concept :

- David Ricardo's Theory of Comparative cost Advantage focuses only on the assumption that Labour is the only factor of production. It ignores the concept of Opportunity Costs.
- In 1930s, Haberler refined the Comparative Cost Advantage Theory with the introduction of Opportunity Costs.
- Accordingly, each Country will specialize and export the Product in which it has lower Opportunity Costs.

(B) Conceptual Difficulties :

- No uniformity / agreement in definition of National Income, and using of multiple measures (GDP, GNP, etc.)
- Difficulties of Measuring Some Services in Money Terms, e.g. Services of Housewife, Hobbies of an Individual.
- Impact of Illegal Activities in the Economy/ Growth of "Black Economy", e.g. Smuggling, Drug Trafficking and all Parallel Market transactions,
- Impact of Price Rise, i.e. Increase in National Income due to prices, without any increase in "real" output,
- Exclusion of Capital Gains or Losses accruing to Property Owners by increase or decrease in the Market Value of their Assets,
- No differentiation between impact of Welfare vs Non Welfare Activities in measurement of National Income,
- Over – emphasis on mere Total GDP, rather than Per Capita GDP that signifies real standard of living,
- Exclusion of qualitative factors like impact of quality, technology, innovations, etc.
- Exclusion of non – market, non – economic contributors to social well – being and welfare,
- Focus on "Monetary" welfare, rather than "real welfare" e.g. leisure time, community feeling, etc.

(C) Common Access Resources / Common Pool Resources :

Point	Description
Meaning	These are both Rival and Non – Excludable Goods, generally available free of charge. (a) Rival : Their consumption by one person lessens the benefits available for others. (b) Non – Excludable : People cannot be excluded from using them.
Examples	Forest Resources, Minerals, Oil and Natural Gas Deposits in Nature, Fisheries, Common Pastures, Rivers, Sea, Backwaters, Earth's

	Atmosphere, Public Roads, Public Parks, etc.
Depletion Quick/Degradation	<p>(a) Price Mechanism does not apply to Common Resources. So, Producers and Consumers do not pay for these resources and thus, they may overuse them and cause their depletion and degradation.</p> <p>(b) This creates threat to the sustainability of these resources and, also the availability of common access resources for future generations.</p> <p>(c) This problem of overuse to the disadvantage of the entire world, is described by the term "Tragedy of the Commons".</p>

(D) Home Currency Appreciation

- **Export** : Depreciation increases the relative price of a Country's exports. Foreigners pay more for the country's products, Export Demand decreases.
- **Domestic Inflation** : If Imported Goods are a significant portion of the domestic consumption, there will be reduction in Inflation levels.

Answer : 8

A. 1. In a Two – Sector Economy, at Equilibrium Level, $Y = C + I$.
Also, Saving (S) = Investment (I) = 6,000

$$\text{So, } Y = 1,000 + 0.6Y + 6,000$$

$$\text{On solving, } Y - 0.6Y = 7,000. \text{ So } Y = \frac{7,000}{0.40} = \mathbf{17,500}.$$

2. At this Equilibrium Level, since Investment (I) = 6,000 (same as Savings),
Consumption (C) = $Y - I = \mathbf{11,500}$.

3. Also, at Equilibrium Level, Saving(S) = Investment (I) = 6,000. Hence, $\Delta I = 10\%$ of 6,000 = **600**.

4. Investment Multiplier = $\frac{1}{1-MPC} = \frac{1}{1-0.60} = 2.5$ times.

$$\text{Since, } \Delta I = 600, \Delta I = 600, \Delta Y = 2.5 \text{ times} \times 600 = \mathbf{1,500}.$$

$$\text{So, Revised Equilibrium Level of National Income} = 17,500 + 1,500 = \mathbf{19,000}$$

B. Crowding Out :

• **Meaning :**

'Crowding out' effect is the negative effect fiscal policy may generate when spending by government in an economy substitutes private spending. For example, if government provides free computers to students, the demand from students for computers may not be forthcoming.

• **Mechanism**

The interest rates in an economy increase when :

- Government increases its spending by borrowing from the loanable funds from market and thus the demand for loans increases.
- Government increases the budget deficit by selling bonds or treasury bills and the amount of money with the private sector decreases.

Due to high interest, private investments, especially the ones which are interest – sensitive, will be reduced. Fiscal policy becomes ineffective as the decline in private spending partially or completely offset the expansion in demand resulting from an increase in government expenditure.

C. Reasons for holding money as per Liquidity Preference Theory :

According to Keynes' Liquidity Preference Theory', people hold money (M) in cash for three motives :

- (i) **The transaction motive** : People hold cash for current transactions for personal and business exchanges i.e. to bridge the time gap between receipt of income and planned expenditures.
- (ii) **The precautionary motive** : People hold cash to make unanticipated expenditures that may occur due to unforeseen and unpredictable contingencies.
- (iii) **The speculative motive** : This motive reflects people's desire to hold cash in order to be equipped to exploit any attractive investment opportunity requiring cash expenditure. According to Keynes, people demand to hold money balances to take advantage of the future changes in the rate of interest, which is the same as future changes in bond prices.

ANSWER : 9

(A)

Comparison :

	Market Prices	Factor cost
(a)	Market Prices refer to the Final Money Value of goods & services, i.e. Net Value Added in the course of production of goods & services.	Net Value Added by each Entity gets distributed as Income to the Owners of Factors of Production, i.e. as Rent, Wages, Interest and Profits for the Owners of Land, Labour, Capital and Entrepreneurship respectively. This total is called Factor Cost.
(b)	Measurement at Market Prices constitute external sale price angle.	Measurement at Factor Cost constitute internal value addition angle.
(c)	Value at Market Prices = Value at Factor Cost Add : Indirect Taxes Less : Subsidies	Value at Factor Cost = Value at Market Prices Less : Indirect Taxes Add : Subsidies

(B) Features : Fiscal Policy

- (a) is designed to influence the pattern and level of economic activity in a country.
- (b) is in the nature of a demand – side policy.
- (c) does not assume full employment level. [Note: An economy which is producing at full – employment level does not require Government action in the form of Fiscal Policy.]
- (d) is aimed at managing macro – economic aggregates, but has micro – economic impact also.

(C)

Item	Computation (Rs. Crores)
M1	Currency held by the Public + Net Demand Deposits of Banks (CASA Deposits) + Other Deposits of RBI. = 7,000 + (13,000 – 2,000) + 4,000 = 22,000
M2	M1 + Savings Deposits with Post Office (PO) Savings Banks = 22,000 + 8,000 = 30,000
M3	M1 + Net Time Deposits with the Banking System = 22,000 + 28,000 = 50,000

M4	M3 + Total Deposits with PO Savings Banks (excluding NSC) = 50,000 + (19,000 – 4,000) = 65,000
----	---

Answer :10

(A) Market Failure : Market Failure occurs, when the free Market leads to misallocation of the Society's Scarce Resources such that there is either -
 (a) Over – Production of particular Goods and Services, or } Leading to a less than
 (b) Under – production of particular Goods and Services } Optimal Outcome.

❖ **Reason:** Perfectly Competitive Markets work efficiently. However, the pre – requisites of such Market are not always present in the practical world. This leads to Market Failure (or) inefficiency of Markets.

(B) The impact of WTO Agreements is on every economic activity – agriculture, trading, service or manufacturing. The impact of WTO involve both threats and opportunities, and are summarized below -

- 1. Entrepreneurship :** World markets are opening up due to lowering of tariffs and dismantling of other restrictions in developed and developing countries. Enlightened Entrepreneurs have opportunities to benefit from their comparative advantages. Entrepreneurial Ability (knowledge based) will come to fore in the new environment.
- 2. Developing vs Developed Countries :** Developing Countries may have greater opportunities in sectors in which they have cost – based comparative advantages e.g. Textiles, Agriculture, etc. Developed Countries will benefit by opening of Service Sector and tightening of IPRs. However, without corresponding reforms in their domestic economic policies developing countries may fail to benefit from WTO Regime.
- 3. Competitive Domestic Markets :** Domestic Markets will be increasingly threatened because of lowering of tariffs leading to free entry of Foreign Goods and because of Foreign Companies establishing manufacturing based locally.
- 4. Competitive Export Markets :** Export Markets will become tougher because of competition among Developing Countries having similar comparative advantages.
- 5. Standardization:** “Standards” and Rules are brought in almost every aspect of manufacturing / services / trading. Products from Developing Countries are likely to face tougher quality standards in developed markets.
- 6. Business Process Re – engineering :** Every Company, whether serving domestic or international market, will have to undertake internal exercises to identify factors affecting its international competitiveness in terms of cost and quality, and see if it can stay competitive once the product becomes freely importable or tariffs are further lowered or both.
- 7. Effective negotiations :** The Governments and Nations that are in constant touch with their Industries and affected groups will be able to determine with clarity how and what should be negotiated at multilateral negotiations to be best of their advantage.
- 8. WTO vs Closed Economy Outlook :** Liberalization of International Trade, deregulation and privatization of internal economy, have now been strengthened and legalized under WTO. The choice before Countries in adopting a direction other

than this, has become almost unrealizable. Countries have moved swiftly in re – defining their domestic and international trade policies creating a winning environment for their businesses.

(C) Floating vs Fixed Exchange Rate Regimes :

Point	Floating Exchange Rate Regime	Fixed Exchange Rate Regime
Determinant of Rate	Market forces of Demand for and Supply of Currency.	As announced or decreed by the Country's Central Bank and /or Government.
Target Rate	There is no pre – determined Target Rate.	As announced by Central Bank/ Government.
Role of Govt and /or Central Bank	Only for moderating the FX Rate and preventing undue fluctuation in the FX Rate. No interference for setting/ establishing a FX Rate level.	For determination / announcement of the FX Rate level, and also for ensuring that the rate is maintained.
Stability in Rate	FX Rate keeps on changing based on market factors.	FX Rate generally remains stable and only a small variation is possible.

Answer : 11

(A)

GDP at Market Prices = GNP at market Prices (since there is no Net Factor Income from abroad)	500
Less : Depreciation	50
Net National Product at Market Prices	450
Less : Net Indirect Taxes = Indirect Taxes less Subsidies	30 – 0 = 30
Net National Product at Factor Cost	420
Add: Incomes Received but not “earned”, i.e. Transfer Payments	Nil
Less : Income Earned, but not received, e.g. Contributions to Social Insurance, etc.	Nil
Personal Income	420
Less: Personal Income Taxes	20
Personal Disposable Income	400

Note : Personal Disposable Income comprises Net Consumption (200 – 20) = 180 + Savings (for Investment) 220 = 400.

(B) Arguments against Government Intervention

1. Government Intervention do not imply that Markets are replaced by Government Action. Government can act only as a complement rather than as a substitute to the Market system in an Economy.
2. Governments may not always be unbiased and benevolent.
3. Individuals may use Government as a Mechanism for maximizing their self – interest.

4. Governments are likely to commit serious errors in its attempt to correct Market Failure.
5. Instead of eliminating Market Distortions, sometimes Governments may contribute to generate them. Such Government Failures may happen due to – (a) inadequate information, (b) conflicting objectives, and (c) administrative costs involved in Government Intervention.
6. In certain cases, the Costs incurred by Government to deal with some Market Failure could be greater than the Cost of the Market Failure itself.
7. Government Intervention may produce fresh and more serious problems than the ones sought to be rectified.
8. Government Intervention is ineffective if it causes wastage of resources expended for the intervention.

(C) LAF Objectives : Its objective is to assist Banks to adjust their day to day mismatches in Liquidity. Currently, RBI provides Financial Accommodation to the Commercial Banks through Repos / Reverse Repos under this Facility.

MSF Objectives : It has been introduced by RBI with the main aim to –
(a) Reduce Volatility in the Overnight Lending Rates in the Inter – Bank market, and
(b) Enable smooth Monetary Transmission.

(D) Principles :

1. Member countries will consult each other concerning trade problems
2. GATT provides a framework for negotiation and embodies results of negotiation in a legal environment.
3. Trade should be conducted on a non – discriminatory basis.