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**SUGGESTED SOLUTION**

**CA INTERMEDIATE**

**SUBJECT- ECONOMICS**

**Test Code – CIM 8559**

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### **ANSWER 1(A)**

Richard Musgrave, in his classic treatise 'The Theory of Public Finance' (1959), introduced the three branch taxonomy of the role of government in a market economy. The objective of the economic system and the role of government is to improve the wellbeing of individuals or households. According to 'Musgrave Three-Function Framework', the functions of government are to be separated into three, namely, resource allocation, (efficiency), income redistribution (fairness) and macroeconomic stabilization. The allocation and distribution functions are primarily microeconomic functions, while stabilization is a macroeconomic function. The allocation function aims to correct the sources of inefficiency in the economic system while the distribution role ensures that the distribution of wealth and income is fair. The stabilization branch is to ensure achievement of macroeconomic stability, maintenance of high levels of employment and price stability.

**(3 MARKS)**

### **ANSWER 1(B)**

#### **Deterrents to Foreign Direct Investment (FDI)**

- (i) Poor macro-economic environment, such as, infrastructure lags, high rates of inflation and continuing instability, balance of payment deficits, exchange rate volatility, unfavourable tax regime (including double taxation), small size of market and lack of potential for its growth and poor track-record of investments.
- (ii) Unfavourable resource and labour market conditions such as poor natural and human resources, rigidity in the labour market, low literacy, low labour skills, language barriers and high rates of industrial disputes
- (iii) Unfavourable legal and regulatory framework such as absence of well -defined property rights, lack of security to life and property, stringent regulations, cumbersome legal formalities and delays, bureaucracy and corruption and political instability.
- (iv) Lack of host country trade openness viz. lack of openness, prevalence of non- tariff barriers, lack of a general spirit of friendliness towards foreign investors, lack of facilities for immigration and employment of foreign technical and administrative personnel.

**(2 MARKS)**

### **ANSWER 1(C)**

A quasi-public good or near-public good has many but not all the characteristics of a public good. These are goods which have an element of non-excludability and non- rivalry.

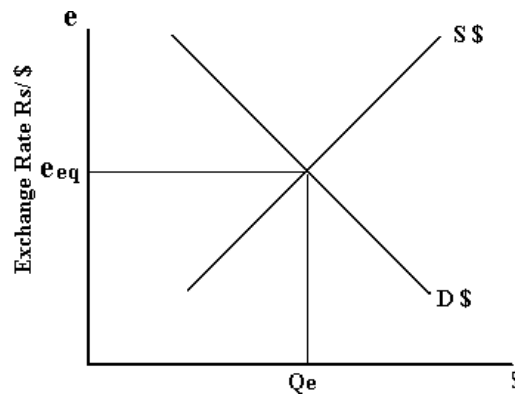
Quasi public goods are:

- (i) Not completely non rival. For example, public roads wi-fi networks and public parks do not get congested so as to reduce the space available for others when extra consumers use them only up to an optimal point. When more people use it beyond that, the amount others can benefit from these is reduced to some extent, because there will be increased congestion.
- (ii) It is easy to keep people away from quasi public goods by charging a price or fee. For example, it is possible to exclude some users by building toll booths to charge for road usage on congested routes. Other examples are education, and health services. It is easy to keep people away from them by charging a price or fee. However, it is undesirable to keep people away from such goods because the society would be better off if more people consume them. This particular characteristic namely, the combination of virtually infinite benefits and the ability to charge a price results in some quasi-public goods being sold through markets and others being provided by government.

**(2 MARKS)**

### ANSWER 1(D)

Under a floating exchange rate system, the supply of and demand for foreign exchange in the domestic foreign exchange market determine the external value of the domestic currency, or in other words, a country's nominal exchange rate. Similar to any standard market, the exchange market also faces a downward-sloping demand curve and an upward-sloping supply curve.



#### Determination of Nominal Exchange Rate

The equilibrium rate of exchange is determined by the interaction of the supply and demand for a particular foreign currency. In the figure above, the demand curve ( $D\$$ ) and supply curve ( $S\$$ ) of dollars intersect to determine equilibrium exchange rate  $e_{eq}$  with  $Q_e$  as the equilibrium quantity of dollars exchanged.

(3 MARKS)

### ANSWER 2(A)

#### 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.

(3 MARKS)

### ANSWER 2(B)

(i) Productivity of labour (output per labour hour = the volume of output produced per unit of labour input)

= output / input of labour hours

Output of commodity	Units in Country X	Units in Country Y
Sugar	0.5	0.20
Rice	0.25	0.40

(ii) A country has an **absolute advantage** in producing a good over another country if it requires fewer resources to produce that good. Since one hour of labour time produces 0.5 units of sugar in country X against 0.20 units in country Y, Country X has absolute advantage in production of sugar.

(iii) Since one hour of labour time produces 0.40 units of rice in country Y against 0.25 units in country X, Country Y has absolute advantage in production of rice.

(3 MARKS)

### ANSWER 2(C)

Optimal output is the ideal quantity of output that ensures maximum level of social welfare. This will occur at a level of output where social marginal cost (SMC) = social marginal benefit. (SMB) At this level of output the society's resources are utilised in the most efficient way.

(2 MARKS)

### ANSWER 2(D)

Local content policies requiring the purchase or use by a foreign enterprise of domestic products and employment of the local workforce seek to ensure that the maximum benefits from production activities accrue to local economic actors. These are essentially aimed at reducing the volume or value of imports or at restraining the employment of foreign labour.

(2 MARKS)

### ANSWER 3(A)

Non-discretionary fiscal policy or automatic stabilizers are part of the structure of the economy and are 'built-in' fiscal mechanisms that operate automatically to reduce the expansions and contractions of the business cycle. It occurs through automatic adjustments in government expenditures and taxes without any deliberate governmental action i.e. by limiting the increase in disposable income during an expansionary phase and limiting the decrease in disposable income during the contraction phase of the business cycle.

(3 MARKS)

### ANSWER 3(B)

#### Modes of foreign direct investment (FDI)

Foreign direct investment is defined as the process whereby the resident of one country (i.e. home country) acquires more than 10 percent ownership of an asset in another country (i.e. the host country) and such movement of capital involves ownership, control as well as management of the asset in the host country. Various modes are:

- (i) Opening of a subsidiary or associate company in a foreign country,
- (ii) Equity injection into an overseas company,
- (iii) Acquiring a controlling interest in an existing foreign company,
- (iv) Mergers and acquisitions (M&A)
- (v) Joint venture with a foreign company.
- (vi) Green field investment (establishment of a new overseas affiliate for freshly starting production by a parent company).

**(3 MARKS)**

**ANSWER 3(C)**

Common access resources or common pool resources are a special class of impure public goods which are non-excludable as people cannot be excluded from using them. These are rival in nature and their consumption lessens the benefits available for others. This rival nature of common resources is what distinguishes them from pure public goods, which exhibit both non-excludability and non-rivalry in consumption. They are generally available free of charge. Some important natural resources fall into this category.

Examples of common access resources are fisheries, common pastures, rivers, sea, backwaters biodiversity etc. The earth's atmosphere is perhaps the best example. Emissions of carbon dioxide and other greenhouse gases have led to the depletion of the ozone layer endangering environmental sustainability. Although nations are aware of the fact that reduced global warming would benefit everyone, they have an incentive to free ride, with the result that nothing positive is likely to be done to correct the problem.

**(2 MARKS)**

**ANSWER 3(D)**

The rate between Y and Z which is derived from the given rates of another set of two pairs of currency (say, X and Y, and, X and Z) is called cross rate.

**(2 MARKS)**

**ANSWER 4(A)**

Market failure is a situation in which the free market with an unrestricted price system determined by forces of supply and demand leads to misallocation of society's scarce resources in the sense that there is either overproduction or underproduction of particular goods and services leading to a less than optimal outcome. The major reasons for market failure and economic inefficiency include:

- (i) Though perfectly competitive markets work efficiently, most often the prerequisites of competition are unlikely to be present in an economy.
- (ii) Market power of firms enables them to act as price makers and keep the level of prices and output that give them positive economic profits.
- (iii) Externalities hinder the ability of market prices to convey accurate information about how much to produce and how much to buy
- (iv) Public goods are not produced at all or produced less than optimal quantities due to its special characteristics such as indivisibility, non - excludability and non-rivalry.
- (v) Free rider problem causing overuse, degradation and depletion of common resources
- (vi) Information failure manifest in asymmetric information, adverse selection and moral hazard.

**(3 MARKS)**

**ANSWER 4(B)**

Anti-dumping measures consist of imposition of additional import duties to offset the effects of dumping. These measures are initiated as safeguards to offset the foreign firm's unfair price advantage. This is justified only if the domestic industry is seriously injured by import competition, and protection is in the national interest (that is, the associated costs to consumers would be less than the benefits that would accrue to producers).

**(2 MARKS)**

**ANSWER 4(C)**

Stabilization function is one of the key functions of fiscal policy and aims at eliminating macroeconomic fluctuations arising from suboptimal allocation. The stabilization function is concerned with the performance of the aggregate economy in terms of labour employment and capital utilization, overall output and income, general price levels, economic growth and balance of international payments. Government's stabilization intervention may be through monetary policy as well as fiscal policy. Monetary policy has a singular objective of controlling the size of money supply and interest rate in the economy, while fiscal policy aims at changing aggregate demand by suitable changes in government spending and taxes.

**(3 MARKS)**

**ANSWER 4(D)**

The World Trade Organization has a three-tier system of decision making. The WTO's top level decision-making body is the Ministerial Conference which can take decisions on all matters under any of the multilateral trade agreements. The Ministerial Conference meets at least once every two years. The next level is the General Council which meets several times a year at the Geneva headquarters. The General Council also meets as the Trade Policy Review Body and the Dispute Settlement Body. At the next level, the Goods Council, Services Council and Intellectual Property (TRIPS) Council report to the General Council. These councils are responsible for overseeing the implementation of the WTO agreements in their respective areas of specialisation. The three also have subsidiary bodies. Numerous specialized committees, working groups and working parties deal with the individual agreements.

**(2 MARKS)**

**ANSWER 5(A)**

Economic efficiency increases due to quantitative and qualitative benefits of extended division of labour, economies of large scale production, betterment of manufacturing capabilities, increased competitiveness and profitability by adoption of cost reducing technology and business practices and decrease in the likelihood of domestic monopolies. Efficient deployment of productive resources - natural, human, industrial and financial resources ensures productivity gains.

Mercantilist argued that trade is a zero sum game. Mercantilism advocated maximizing exports in order to bring in more precious metals and minimizing imports through the state imposing very high tariffs on foreign goods. This view argues that trade is a 'zero-sum game', with winners who win does so only at the expense of losers and one country's gain is equal to another country's loss, so that the net change in wealth or benefits among the participants is zero.

**(3 MARKS)**

**ANSWER 5(B)**

Regional Trade Agreements (RTAs) are defined as grouping of countries, which are formed under the objective of reducing barriers to trade between member countries; not necessarily belonging to the same geographical region.

**(2 MARKS)**

**ANSWER 5(C)**

When prices of certain essential commodities rise excessively, government may resort to controls in the form of price ceilings (also called maximum price) for making a resource or commodity available to all at reasonable prices. For example: maximum prices of food grains and essential items are set by government during times of scarcity. A price ceiling which is set below the prevailing market clearing price will generate excess demand over supply.

With the objective of ensuring stability in prices and distribution, governments often intervene in grain markets through building and maintenance of buffer stocks. It involves purchases from the market during good harvest and releasing stocks during periods when production is below average.

**(3 MARKS)**

**ANSWER 5(D)**

Under a floating rate system, home currency depreciates when its value falls with respect to the value of another currency or a basket of other currencies i.e there is an increase in the home currency price of the foreign currency. For example, if the Rupee dollar exchange rate in the month of January is \$1 = Rs. 70 and Rs. 72 in June, then the Indian Rupee has depreciated in its value with respect to the US dollar and the value of US dollar has appreciated in terms of the Indian Rupee.

On the contrary, home currency appreciates when its value increases with respect to the value of another currency or a basket of other currencies i.e. there is a decrease in the home currency price of foreign currency. For example, if the Rupee dollar exchange rate in the month of January is \$1 = Rs. 72 and Rs. 70 in June, then the Indian Rupee has appreciated in its value with respect to the US dollar and the value of US dollar has depreciated in terms of the Indian Rupee.

**(2 MARKS)**