SUGGESTED SOLUTION

CA INTERMEDIATE

SUBJECT- ECONOMICS

Test Code – CIM 8463

BRANCH - () (Date :)

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ANSWER -1

ANSWER –A

Few important points which one needs to bear in mind while calculating National Income are -

(i) The value of only final goods and services or only the value added by the production process would be included in GDP. By 'value added' we mean the difference between value of output and purchase of intermediate goods.

(ii) Intermediate consumption consists of the value of the goods and services consumed as inputs by a process of production, excluding fixed assets whose consumption is recorded as consumption of fixed capital. Intermediate goods used to produce other goods rather than being sold to final purchasers are not counted as it would involve double counting.

(iii) Gross Domestic Product (GDP) is a measure of production activity which covers all production activities recognized by SNA called the 'production boundary'.

(iv) Economic activities include all human activities which create goods and services that are exchanged in a market and valued at market price. On the other hand, Non-economic activities are those which produce goods and services, but since these are not exchanged in a market transaction they do not command any market value; for e.g. hobbies, housekeeping and child rearing services of home makers and services of family members that are done out of love and affection.

(v) National income is a 'flow' measure of output per time period—for example, per year—and includes only those goods and services produced in the current period i.e. produced during the time interval under consideration. The value of market transactions such as exchange of goods which already exist or are previously produced, do not enter into the calculation of national income. Therefore, the value of assets such as stocks and bonds which are exchanged during the pertinent period are not included in national income as these do not directly involve current production of goods and services.

(vi) Two types of goods used in the production process are counted in GDP namely, capital goods (business plant and equipment purchases) and inventory investment—the net change in inventories of final goods awaiting sale or of materials used in the production which may be positive or negative

(5 MARKS)

ANSWER –B

Empirical analysis of money supply is important for two reasons:

1. It **<u>facilitates analysis of monetary developments</u>** in order to provide a deeper understanding of the causes of money growth.
2. It is **<u>essential from a monetary policy perspective as it provides a framework to evaluate whether the stock of money in the economy</u>** is consistent with the standards for price stability and to understand the nature of deviations from this standard. The central banks all over the world adopt monetary policy to stabilise price level and GDP growth by directly controlling the supply of money. This is achieved mainly by managing the quantity of monetary base. The success of monetary policy depends to a large extent on

the controllability of money supply and the monetary base.

(3 MARKS)

ANSWER –C

Reserve Money = Currency in circulation + Bankers' deposits with the RBI + Other deposits with the RBI

=15428.40 + 4596.18 + 183.30

= 20207.88

(2 MARKS)

ANSWER -2

ANSWER –A

Investment Multiplier K = $\Delta Y/\Delta I$

= 12,000/ 4,000 = 3

(2 MARKS)

ANSWER –B

Keynes argued that, in the short run, investment is best viewed as an autonomous expenditure**,** that is, it is independent of people's income. The Keynesian model assumes that the planned level of investment expenditure is constant with respect to current income. Investment is determined by factors other than income such as business expectations and economic policy.

(3 MARKS)

ANSWER –C

A unit of account is a common unit for measuring how much something is worth. The monetary unit (for e.g. Rupee, Dollar) serves as a numeraire or common measure value in terms of which the value of all goods, services, assets, liabilities, income, expenditure etc are measured and expressed. This helps in measuring and fixing the exchange values in terms of a common unit and avoids the problem of recording and expressing the value of each commodity in terms of quantities of other goods. Use of money as a unit of account thus

- reduces the number of exchange ratios between goods and services
- makes it possible to keep business accounts
- allows meaningful interpretation of prices, costs, and profits, and
- facilitates a system of trade through orderly pricing, comparison of value and rational economic choices.

(5 MARKS)

ANSWER -3

ANSWER –A

High powered money is also known as reserve money which determines the level of liquidity and price level in the economy.

Reserve Money = Net RBI Credit to the Government + RBI credit to the Commercial sector+ RBI's claims on banks+ RBI's Net foreign assets+ Government's currency liabilities to the public- RBI's net non-monetary liabilities

= 41561.2 + 18459.3 + 31456.2 + 10456.1 + 21417.1 - 24981.2 = 98368.7 million

(3 MARKS)

ANSWER –B

There are many conceptual difficulties related to measurement which are difficult to resolve. A few examples are:

(a) lack of an agreed definition of national income,

(b) accurate distinction between final goods and intermediate goods,

(c) issue of transfer payments,

(d) services of durable goods,

(e) difficulty of incorporating distribution of income

(f) valuation of a new good at constant prices, and

(g) valuation of government services

(h) valuation of services rendered without remuneration

(2 MARKS)

ANSWER –C

(i) Consumption expenditure at equilibrium level of National Income

Y = C + I [AD = C + I]

Putting the value of Investment Expenditure (I) = Rs.500 Crores and Income (Y) = Rs. 2000 crores, we get C = 2,000 – 500

C= Rs.1500 Crores

(ii) Marginal Propensity to Save (MPS)

Consumption function is given by

C = a + bY

1500 = 100 + 2000 b

2000 b = 1400

MPC = 0.7

MPS = 1-MPC = 1-0.7 = 0.3

(iii) Break-even level of Income attained at break-even point = C = Y

Putting Y = C

Y = 100 + 0.7 Y

0.3Y = 100

Y = 333.33

(5 MARKS)

ANSWER -4

ANSWER –A

M1= Currency with the public+ demand deposits of banks+ other deposits of the RBI

= 15473.2 + 6943.1+ 501.2 = 22917.5 million

(2 MARKS)

ANSWER –B

The operating framework relates to all aspects of implementation of monetary policy. It primarily involves three major aspects, namely,

(i) Choosing the operating target
(ii) Choosing the intermediate target, and
(iii) Choosing the policy instruments.

The operating target refers to the variable (for e.g. inflation) that monetary policy can influence with its actions. The intermediate target (e.g. economic stability) is a variable which the central bank can hope to influence to a reasonable degree through the operating target and which displays a predictable and stable relationship with the goal variables. The monetary policy instruments are the various tools that a central bank can use to influence money market and credit conditions and purse its monetary policy objectives.

Instruments :

CRR :
CRR refers to fraction of Total NDTL net of commercial Bank of India which it should maintain as cash deposits with RBI. CRR is mandatory Reserve for all commercial bank. Bank have to pay monetary penalty to they don't maintain CRR. CRR is applicable only to commercial bank & not applicable to NBFC. RBI may not given any interest on CRR. Currently CRR is 4%.

Statutory Liquidity Ratio :
SLR is a percentage of NDTL that every commercial bank has to keep with itself either in cash, gold or government dated securities. Currently SLR is 20%. As per 2017 during inflation, SLR increases, and during deflation SLR decreases. It is Mandatory to maintain SLR with RBI. Failure to maintain will attract Monetary penalty. Not applicable to NBFC.

Liquidity Adjustments Facilities :
LAF started in year 2000. (RBI is Bankers Bank), LAF is a window available with central bank known as discount window which provides financial accommodation to commercial banks, it helps at the time of Liquidity shortage and control short term Interest rate, through Repo and. Reverse repo auction

1. Repo Auction : It is a rate at which commercial bank borrows money from central bank by keeping some security mortgage which could be repurchased @ later stage. At present rate is 6%.
2. Reverse Repo : It is a percentage that central bank borrows from commercial bank by keeping security as mortgage currently it is 5.75%.

(3 MARKS)

ANSWER –C

According to Milton Friedman, Demand for money is affected by the same factors as demand for any other asset, namely

1. Permanent income.
2. Relative returns on assets. (which incorporate risk)

Friedman maintains that it is permanent income – and not current income as in the Keynesian theory – that determines the demand for money. Permanent income which is Friedman's measure of wealth is the present expected value of all future income. To Friedman, money is a good as any other durable consumption good and its demand is a function of a great number of factors.

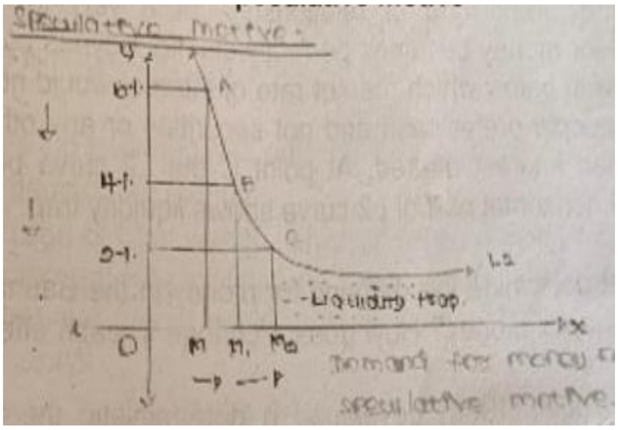
Friedman identified the following four determinants of the demand for money. The nominal demand for money:

- is a function of total wealth, which is represented by permanent income divided by the discount rate, defined as the average return on the five asset classes in the monetarist theory world, namely money, bonds, equity, physical capital and human capital.
- is positively related to the price level, P. If the price level rises the demand for money increases and vice versa.
- rises, if the opportunity costs of money holdings (i.e. returns on bonds and stock) decline and vice versa.
- is influenced by inflation, a positive inflation rate reduces the real value of money balances, thereby increasing the opportunity costs of money holdings.

(3 MARKS)

ANSWER –D

Demand for money for transaction & precautionary motive
Speculative motive



Demand for money for speculative motive

- Demand for money for speculative motive is related to store of value function of money.
- Speculative demand is also known as Asset demand for money
- People have the alternative to hold the either cash or financial asset like government bonds & equities
- Speculative demand also relates to uncertainty

- The cash held under this motive is used to make speculative gain by dealing on bond whose price fluctuates.
- If bond prices are expected to rise, businessman will buy bonds on other hand is bond price are expected to fall, businessman will sell bonds to avoid capital losses.
- However Market interest rate is expected to fall, businessman, if interest rate is expected to rise they will sell bonds. This implies that bond price and MRI are inversely related to each other

  Market rate interest vs BONDS

BONDS	MRI -----------------FD
↓ 1000/-5% = 50/-	10% 8% (ROI rises) 7.5% 8.5% 500 × 10% = 50/-

- Equal amount of return (i.e.) rs. 50 will be earned by making a financial investment of just Rs. 500 hence a Rs. 1,000 bond value has declined to Rs. 500.
- Keynes assumes that at very high rate interest (high bond price) all other asset holder will be bulls.
- On other hand, at low rate of interest (high bond price) all other asset holder will be bears
- Speculative demand for money increases as market interest rate fall and vice versa. Demand for money held under speculative motive is as demand for idle cash balance L2 = F(r) →Rate of interest

(2 MARKS)

ANSWER -5

ANSWER –A

Personal Income = Net domestic product accruing to private sector + Net factor income from abroad + Net current transfers from government + Net current transfers from rest of the world + interest on National debt – Corporation tax – Undistributed profits of corporations

= 700+10+25+20+40-65-50

= 680 Crores

(3 MARKS)

ANSWER –B

Economic activities as distinguished from non-economic activities, include all human activities which create goods and services that can be valued at market price**. Non-economic activities** are those which produce goods and service, but are not exchanged in a market transaction so that do not command any market value.

(3 MARKS)

ANSWER –C

The credit multiplier is the reciprocal of the required reserve ratio.

$$\text{Credit Multiplier} = \frac{1}{\text{Required Reserve Ratio}}$$

For RRR = 0.05 Credit Multiplier = 1/ 0.05 = 20

For RRR = 0.08 Credit Multiplier = 1/ 0.08 = 12.5

Credit Creation = Initial Deposit x 1/RRR

For RRR = 0.05, Credit creation will be 3000x 1/0.05 = 60,000/

For RRR = 0.08, Credit creation will be 3000x 1/0.08 = 37,500/

(2 MARKS)

ANSWER –D

Money performs many important functions in an economy.

(i) Money is a **convenient medium of exchange or it is an instrument that facilitates easy exchange of goods and services**. Money, though not having any inherent power to directly satisfy human wants, by acting as a medium of exchange, it commands purchasing power and its possession enables us to purchase goods and services to satisfy our wants. By acting as an intermediary, money increases the ease of trade and reduces the inefficiency and transaction costs involved in a barter exchange. By decomposing the single barter transaction into two separate transactions of sale and purchase, money eliminates the need for double coincidence of wants. Money also facilitates separation of transactions both in time and place and this in turn enables us to economize on time and efforts involved in transactions.

(ii) Money is a **'common measure of value'**. The monetary unit is the unit of measurement in terms of which the value of all goods and services is measured and expressed. It is convenient to trade all commodities in exchange for a single commodity. So also, it is convenient to measure the prices of all commodities in terms of a single unit, rather than rec ord the relative price of every good in terms of every other good. A common unit of account facilitates a system of orderly pricing which is crucial for rational economic choices. Goods and services which are otherwise not comparable are made comparable through expressing the worth of each in terms of money.

(iii) Money serves as a **unit or standard of deferred payment i.e money facilitates recording of deferred promises to pay**. Money is the unit in terms of which future payments are contracted or stated. However, variations in the purchasing power of money due to inflation or deflation, reduces the efficacy of money in this function.

(iv) Like nearly all other assets, money is a **store of value. People prefer to hold it as an asset, that is, as part of their stock of wealth**. The splitting of purchases and sale into two transactions involves a separation in both time and space. This separation is possible because money can be used as a store of value or store of means of payment during the intervening time. Again, rather than spending one's money at present, one can store it for use at some future time. Thus, money functions as a temporary abode of purchasing power in order to efficiently perform its medium of exchange function. Money also functions as a permanent store of value. Money is the only asset which has perfect liquidity. **(2 MARKS)**