SUGGESTED SOLUTION

CA INTERMEDIATE N'19

SUBJECT- F.M. AND ECO

Test Code - PIN 5073

BRANCH - () (Date :)

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ANSWER-1
ANSWER-A

Firm A Ltd. (pure equity): unlevered firm: EAT = EBIT (1 – t)

= EBT × 0.7 = Rs. 2,50,000 × 0.7 = Rs. 1,75,000

(since, EBIT = EBT as there is no debt)

Value of unlevered firm A = EAT / Equity capitalization rate

= Rs.1,75,000/ 20%

= Rs. 8,75,000

Firm B Ltd. (levered):

Value of levered firm = Value of equity + Value of debt

= Rs. 8,75,000 + (10,00,000) × 0.3

= Rs. 11,75,000

(2.5 MARKS*2 = 5 MARKS)

ANSWER-B

In this case the company has paid dividend of Rs.2 per share during the last year. The growth rate (g) is 5%. Then, the current year dividend (D_1) with the expected growth rate of 5% will be Rs. 2.10

The share price is = $P_O = \frac{D1}{Ke-g}$

= Rs. 2.10/ 0.155 – 0.05 = Rs. 20 **(2 MARKS)**

(i) In case the growth rate rises to 8% then the dividend for the current year (D_1) would be Rs. 2.16 and market price would be-

= Rs. 2.16 / 0.155 – 0.08 = Rs. 28.80

(1.5 MARKS)

(ii) In case growth rate falls to 3% then the dividend for the current year (D_1) would be Rs. 2.06 and market price would be-

= Rs. 2.06 / 0.155 – 0.03 = Rs. 16.48

So, the market price of the share is expected to vary in response to change in expected growth rate is dividends.

(1.5 MARKS)

ANSWER-C

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.

(3 MARKS)

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

(2 MARKS)

ANSWER-D

Statement showing the determination of the risk adjusted net present value

Projects	Net cash outlays	Coefficient of variation	Risk adjusted discount rate	Annual cash inflow	PV factor 1-5 years	Discounted cash inflow	Net present value
	(Rs.)			(Rs.)		(Rs.)	(Rs.)
(i)	(ii)	(iii)	(iv)	(v)	(vi)	(vii) = (v) ⍰	(viii) = (vii) – (ii)

						(vi)	
X	2,10,000	1.20	16%	70,000	3.274	2,29,180	19,180
Y	1,20,000	0.80	14%	42,000	3.433	1,44,186	24,186
Z	1,00,000	0.40	12%	30,000	3.605	1,08,150	8,150

(5 MARKS)

ANSWER-2

(i) Statement of Weighted Average Cost of Capital

Project Cost	Financing	Proportion of capital Structure	After tax cost (1 – Tax 50%)	Weighted average cost (%)
Upto Rs. 2 Lakhs	Debt	0.4	10% (1 – 0.5)	0.4 × 5 = 2.0
			= 5%	
	Equity	0.6	12%	0.6 × 12 = 7.2
				9.2%
Above Rs. 2 lakhs & upto to Rs. 5 lakhs	Debt	0.4	11% (1 – 0.5) = 5.5%	0.4 × 5.5 = 2.2
	Equity	0.6	13%	0.6 × 13 = 7.8
				10.0%
Above Rs. 5 lakhs	Debt	0.4	12% (1 – 05) = 6%	0.4 × 6 = 2.4
& upto Rs. 10 lakhs	Equity	0.6	14%	0.6 × 14 = 8.4
				10.8%
Above Rs. 10 lakhs & upto Rs. 20 lakhs	Debt	0.4	13% (1 – 0.5) = 6.5%	0.4 × 6.5 = 2.6
	Equity	0.6	14.5%	0.6 × 14.5 = 8.7
				11.3%

Project	Fund requirement	Cost of Capital
X	Rs. 6.5 lakhs	10.8% (from the above table)
Y	Rs. 14 lakhs	11.3% (from the above table)

(8 MARKS)

(ii) If a project is expected to give after tax return of 10%, it would be acceptable provided its project cost does not exceed Rs. 5 lakhs or, after tax return should be more than or at least equal to the weighted average cost of capital. **(2 MARKS)**

ANSWER-3

Working Notes:

Depreciation on Machine – I = 30,00,000/10 = Rs. 3,00,000

Depreciation on Machine – II = 40,00,000/10 = Rs. 4,00,000

Particulars	Machine-I (Rs.)	Machine – II (Rs.)
Annual Income (before Tax and Depreciation)	12,50,000	17,50,000
Less: Depreciation	3,00,000	4,00,000
Annual Income (before Tax)	9,50,000	13,50,000
Less: Tax @ 30%	(2,85,000)	(4,05,000)
Annual Income (after Tax)	6,65,000	9,45,000
Add: Depreciation	3,00,000	4,00,000
Annual Cash Inflows	9,65,000	13,45,000

	Machine – I				Machine – II		
Year	PV of Re 1 @ 15%	Cash flow	PV	Cumulative PV	Cash flow	PV	Cumulative PV
1	0.870	9,65,000	8,39,550	8,39,550	13,45,000	11,70,150	11,70,150
2	0.756	9,65,000	7,29,540	15,69,090	13,45,000	10,16,820	21,86,970
3	0.658	9,65,000	6,34,970	22,04,060	13,45,000	8,85,010	30,71,980
4	0.572	9,65,000	5,51,980	27,56,040	13,45,000	7,69,340	38,41,320
5	0.497	9,65,000	4,79,605	32,35,645	13,45,000	6,68,465	45,09,785

(6 MARKS)

(i) Discounted Payback Period

Machine – I

Discounted Payback Period = $4 + \frac{(30,00,000 - 27,56,040)}{4,79,605}$

$= 4 + \frac{2,43,960}{4,79,605} = 4 + 0.5087$ = 4.5087 years or 4 years 6.10 months

Machine – II

Discounted Payback Period = $4 + \frac{(40,00,000 - 38,41,320)}{6,68,465}$

$= 4 + \frac{1,58,680}{6,68,465} = 4 + 0.2374$ = 4.2374 years or 4 years 2.85 months

(ii) Net Present Value (NPV)

Machine – I

NPV = 32,35,645 – 30,00,000 = Rs. 2,35,645

Machine – II

NPV = 45,09,785 – 40,00,000 = Rs. 5,09,785

(iii) Profitability Index

Machine – I

Profitability Index = $\frac{32,35,645}{30,00,000} = 1.08$

Machine – II

Profitability Index = $\frac{45,09,785}{40,00,000} = 1.13$

(3*1 = 3 MARKS)

Conclusion: **(1 MARK)**

Method	Machine - I	Machine - II	Rank
Discounted Payback Period	4.51 years	4.24 years	II
Net Present Value	Rs. .2,35,645	Rs. 5,09,785	II
Profitability Index	1.08	1.13	II

ANSWER-4

Statement showing Working Capital Investment for each policy

(Rs. in crore)

	Working Capital Policy		
	Conservative	**Moderate**	**Aggressive**
Current Assets: (i)	4.50	3.90	2.60
Fixed Assets: (ii)	2.60	2.60	2.60
Total Assets: (iii)	7.10	6.50	5.20
Current liabilities: (iv)	2.34	2.34	2.34
Net Worth: (v) = (iii) - (iv)	4.76	4.16	2.86
Total liabilities: (iv) + (v)	7.10	6.50	5.20
Estimated Sales: (vi)	12.30	11.50	10.00
EBIT: (vii)	1.23	1.15	1.00
(a) Net working capital position: (i) - (iv)	2.16	1.56	0.26
(b) Rate of return: (vii) /(iii)	17.32%	17.69%	19.23%
(c) Current ratio: (i)/ (iv)	1.92	1.67	1.11

(3 MARKS)

(ii) Statement Showing Effect of Alternative Financing Policy

(Rs. in crore)

Financing Policy	**Conservative**	**Moderate**	**Aggressive**
Current Assets (i)	3.90	3.90	3.90
Fixed Assets (ii)	2.60	2.60	2.60
Total Assets (iii)	6.50	6.50	6.50
Current Liabilities (iv)	2.34	2.34	2.34
Short term Debt (v)	0.54	1.00	1.50
Total current liabilities	2.88	3.34	3.84

(vi) = (iv) + (v)			
Long term Debt (vii)	1.12	0.66	0.16
Equity Capital (viii)	2.50	2.50	2.50
Total liabilities (ix) = (vi)+(vii)+(viii)	6.50	6.50	6.50
Forecasted Sales	11.50	11.50	11.50
EBIT (x)	1.15	1.15	1.15
Less: Interest on short-term debt	0.06 (12% of Rs.0.54)	0.12 (12% of Rs. 1)	0.18 (12% of Rs. 1.5)
Interest on long term debt	0.18 (16% of Rs.1.12)	0.11 (16% of Rs.0.66)	0.03 (16% of Rs.0.16)
Earnings before tax (EBT) (xi)	0.91	0.92	0.94
Taxes @ 35% (xii)	0.32	0.32	0.33
Earnings after tax: (xiii) = (xi) – (xii)	0.59	0.60	0.61
(a) Net Working Capital Position: (i) - [(iv) + (v)]	1.02	0.56	0.06
(b) Rate of return on shareholders Equity capital : (xiii)/ (viii)	23.6%	24.0%	24.4%
(c) Current Ratio (i) / (vi)	1.35	1.17	1.02

(7 MARKS)

ANSWER-5

Workings:-

Total Assets = Rs. 1 crore

Total Asset Turnover Ratio i.e. = TOTAL SALES/ TOTAL ASSETS = 5

Hence, Total Sales = Rs. 1 Crore X 5 = Rs. 5 crore

(1) Income Statement

	(Rs. in crore)
Sales	5
Less: Variable cost @ 60%	3
Contribution	2
Less: Fixed cost (other than Interest)	0 .2
EBIT (Earnings before interest and tax)	1.8
Less: Interest on debentures (12% x 50 lakhs)	0 .06
EBT (Earning before tax)	1.74
Less: Tax 25%	0.435
EAT (Earning after tax)	1.305

(3 MARKS)

(2) (a) **Operating Leverage**

$$\text{Operating leverage} = \frac{Contribution}{EBIT} = \frac{2}{1.8} = 1.11$$

It indicates fixed cost in cost structure. It indicates sensitivity of earnings before interest and tax (EBIT) to change in sales at a particular level.

(b) **Financial Leverage**

$$\text{Financial Leverage} = \frac{EBIT}{EBT} = \frac{1.8}{1.74} = 1.03$$

The financial leverage is very comfortable since the debt service obligation is small vis-à-vis EBIT.

(c) **Combined Leverage**

$$\text{Combined Leverage} = \frac{Contribution}{EBIT} \times \frac{EBIT}{EBT} = 1.11 \times 1.03 = 1.15$$

Or

$$\frac{Contribution}{EBT} = \frac{2}{1.74} = 1.15$$

The combined leverage studies the choice of fixed cost in cost structure and choice of debt in capital structure. It studies how sensitive the change in EPS is vis-à-vis change in sales.

The leverages- operating, financial and combined are measures of risk.

(7 MARKS)

ANSWER-6

ANSWER-A

There are various factors like price of the product/ service, demand, price of inputs e.g. raw material, labour etc., which is to be managed by an organization on a continuous basis. Proportion of debt also needs to be managed by an organization very delicately. Higher debt requires higher interest and if the cash inflow is not sufficient then it will put lot of pressure to the organization. Both short term and long term creditors will put stress to the firm. If all the above factors are not well managed by the firm, it can create situation known as distress, so financial distress is a position where Cash inflows of a firm are inadequate to meet all its current obligations.

Now if distress continues for a long period of time, firm may have to sell its asset, even many times at a lower price. Further when revenue is inadequate to revive the situation, firm will not be able to meet its obligations and become insolvent. So, insolvency basically means inability of a firm to repay various debts and is a result of continuous financial distress.

(4 MARKS)

ANSWER-B

The limitations of financial ratios are listed below:

(i) **Diversified product lines:** Many businesses operate a large number of divisions in quite different industries. In such cases ratios calculated on the basis of aggregate data cannot be used for inter-firm comparisons.

(ii) **Financial data are badly distorted by inflation:** Historical cost values may be substantially different from true values. Such distortions of financial data are also carried in the financial ratios.

(iii) Seasonal factors may also influence financial data.

(iv) To give a **good shape to the popularly used financial ratios** (like current ratio, debt- equity ratios, etc.): The business may make some year-end adjustments. Such window dressing can change the character of financial ratios which would be different had there been no such change.

(v) **Differences in accounting policies and accounting period:** It can make the accounting data of two firms non-comparable as also the accounting ratios.

(vi) There is no standard set of ratios against which a firm's ratios can be compared: Sometimes a firm's ratios are compared with the industry average. But if a firm desires to be above

the average, then industry average becomes a low standard. On the other hand, for a below average firm, industry averages become too high a standard to achieve.

(vii) **Financial ratios are inter-related, not independent**: Viewed in isolation one ratio may highlight efficiency. But when considered as a set of ratios they may speak differently. Such interdependence among the ratios can be taken care of through multivariate analysis.

(4 MARKS)

ANSWER-C

In dividend price approach, cost of equity capital is computed by dividing the expected dividend by market price per share. This ratio expresses the cost of equity capital in relation to what yield the company should pay to attract investors. It is computed as:

$$Ke = \frac{D1}{P0}$$

Where,

D1 = Dividend per share in period 1

P0 = Market price per share today

(2 MARKS)

ANSWER-7

ANSWER-A

Income Method

GDP_{MP} = Employee compensation (wages and salaries + employers' contribution towards social security schemes) + profits + rent + interest + mixed income + depreciation + net indirect taxes (Indirect taxes - subsidies) GDP_{MP}

= 6,508+ 34 + 1060 + 806+ 682 + 1,000 + 800 = **10,890**

GNP_{MP} = GDP_{MP} + NFIA =10,890+ 40 = **10,930**

Expenditure Method

Y = C + I + G + (X – M)

Y = 7314 + 1442 + 2196+ (1346 –1408)

Y = (7314 + 1442 + 2196) – 62

Y = 10890

GNP_{MP} = GDP_{MP} + NFIA =10,890+ 40 =**10,930**

(3 MARKS)

ANSWER-B

Foreign direct investment is defined as a **process whereby the resident of one country (i.e. home country) acquires 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.** Direct investments are real investments in factories, assets, land, inventories etc. and have three components, viz., equity capital, reinvested earnings and other direct capital in the form of intra-company loans. Foreign direct investment also includes all subsequent investment transactions between the investor and the enterprise and among affiliated enterprises, both incorporated and unincorporated. FDI involves long term relationship and reflects a lasting interest and control. According to the IMF and OECD definitions, the acquisition of at least ten percent of the ordinary shares or voting power in a public or private enterprise by non-resident investors makes it eligible to be categorized as FDI. FDI may be categorized as horizontal, vertical, conglomerate and two- way direct foreign investments which are reciprocal investments.

(3 MARKS)

Benefits of Foreign Direct Investment

Following are the benefits ascribed to foreign investments:

(i) Entry of foreign enterprises usually **fosters competition and generates a competitive environment** in the host country.

(ii) International capital allows countries to finance **more investment than can be supported by domestic savings resulting in higher productivity and enhanced output.**

(2*1=2 MARKS)

ANSWER- C

The Reserve Bank of India (RBI) Act, 1934 was amended on June 27, 2016, for giving a statutory backing to the Monetary Policy Framework Agreement and for setting up a Monetary Policy Committee (MPC). The Monetary Policy Framework Agreement is an agreement reached between the Government of India and the Reserve Bank of India (RBI) on the maximum tolerable inflation rate that the RBI should target to achieve price stability. The amended RBI Act (2016) provides for a statutory basis for the implementation of the 'flexible inflation targeting framework'.

Announcement of an official target range for inflation is known as inflation targeting. The Expert Committee under Urijit Patel to revise the monetary policy framework, in its report in January, 2014 suggested that RBI abandon the 'multiple indicator' approach and make inflation targeting the primary objective of its monetary policy. The inflation target is to be set by the Government of India, in consultation with the Reserve Bank, once in every five years. Accordingly,

- The Central Government has notified 4 per cent Consumer Price Index (CPI) inflation as the target for the period from August 5, 2016 to March 31, 2021 with the upper tolerance limit of 6 percent and the lower tolerance limit of 2 per cent.
- The RBI is mandated to publish a Monetary Policy Report every six months, explaining the sources of inflation and the forecasts of inflation for the coming period of six to eighteen months.

(2 MARKS)

ANSWER-8

ANSWER-A

Point	Description
Meaning	1.Government Borrowings from Public (and its repayment) are covered in this concept. 2. Public Debt may be – (a) Internal – i.e. borrowing from its own people in the country, or (b) External – i.e. borrowing from outside sources. 3. Public Debt may be by way of – **(a) Market Loans** – issue of Treasury Bills (T – Bills) and Government Securities (G – Secs) which are actively traded in Debt Markets, [Note : capital Bonds = Long – Term, and T – Bills = Short – Term] **(b) Small Savings** – non – negotiable and non – transferable Public Borrowings under various schemes – e.g. Public Provident Fund, National Savings Certificates, Kisan Vikas Patra, Sukanya Samriddhi, etc.
Action during Recession	1. Government reduces its Borrowings (e.g. Closure of certain schemes, non – acceptance of fresh deposits), and also repays existing Public Debt. 2. Such action increases the availability of money in the economy and increases Aggregate Demand.
Action during Inflation	1. Government increases its Borrowings (e.g. offering new schemes, acceptance of fresh deposits etc.), and also at attractive rates of interest. 2. Such action wipes out the excess purchasing power in the economy, reducing demand – pull inflation.

(5 MARKS)

ANSWER-B

The Heckscher-Ohlin theory of trade, also referred to as Factor-Endowment Theory of Trade or Modern Theory of Trade, states that comparative advantage in cost of production is explained exclusively by the differences in factor endowments.

A country tends to specialize in the export of a commoditywhose production requires intensive use of its abundant resources and imports a commodity whose production requires intensive use of its scarce resources.

Accordingly, a capital abundant country will produce and export capital intensive goods relatively more cheaply and a labour-abundant country will produce and export labour intensive goods relatively more cheaply than another country.

(3 MARKS)

ANSWER – C

1. **Meaning :** Disposable Income is the **Income which is left with the Individuals after paying Taxes to the Government.**
2. **Computation :** Disposable Income can be computed in any one of the following way –
   (a) Disposable Income = Personal Income (-) Personal Income Taxes.

(2 MARKS)

ANSWER-9

ANSWER-A

If Disposable Income (Y) is	**Rs. 20,000**	**Rs. 25,000**	**Rs. 30,000**
(a) Consumption (C) = 6,000 + 0.75Y	6,000 + (0.75 × 20,000) = Rs. 21,000	6,000 + (0.75 × 25,000) = Rs. 24,750	6,000 + (0.75 × 30,000) = Rs. 28,500
(b) Saving (S) = Y – C **[Note 1]**	20,000 – 21,000 = Dissaving (Rs. 1,000)	25,000 – 24,750 = Rs. 250	30,000 - 28,500 = Rs. 1,500
(c) Autonomous Consumption	**[Note 2]** Rs. 6,000	Rs. 6,000	Rs. 6,000
(d) Induced Consumption = C – a	Rs. 15,000	Rs. 18,750	Rs. 22,500

Note :

1. Saving is the difference between Disposable income and Consumption. It is the difference between the Consumption line and the 45 Degree line at each level of Disposable Income.
2. For the consumption Function C = a + by, where "a" = a constant which represents the positive value of Consumption at Zero level of Disposable Income. Hence, in this case, a = Rs. **6,000**. This is also the point at which the consumption Line intersects the vertical axis (Y – Axis). This is called Autonomous Consumption, i.e. unconnected with Income.
3. Induced Consumption is determined by the level of Income, i.e. it is Income – induced Consumption and is computed as Total Consumption (-) Autonomous Consumption.

(5 MARKS)

ANSWER-B

Changes in SLR chiefly **influence the availability of resources in the banking system for lending**. A rise in SLR -during periods of high liquidity - to lock up a rising fraction of a bank's assets in the form of eligible instruments – reduces the credit creation capacity of banks. A reduction in SLR during periods of economic downturn has the opposite effect.

(2 MARKS)

ANSWER-C

The **principles governing application of SPS measures are** :

- The sanitary and phytosanitary measures are to be **based on scientific principles and should not be inconsistent with the provisions of the SPS agreement**.
- Measures **should not arbitrarily or unjustifiably discriminate between/among members** where identical or similar conditions exist.
- Measures should **not be applied in a way which would constitute a disguised restriction** to international trade.

(3*1 = 3 MARKS)

ANSWER-10

ANSWER-A

Point	Description
Meaning	1. When spending by Government in an economy replaces Private Spending, the latter is said to be crowded out. [**Note :** Government Spending has to "support" and "enhance" private spending, not merely "replace" it. 2. **"Crowing Out" Effect is the negative effect that a Fiscal Policy may generate, when money from the Private sector is "crowded out" to the Public Sector.**
Example	If government provides Free Computers to Students, the demand from students for Computers may not be forthcoming.

(2 MARKS)

ANSWER-B

Arbitrage Concept in Forex Market	1. Arbitrage refers to the **practice of making risk – less profits by intelligently exploiting price differences of an Asset at different dealing locations.** 2. When price differences occur in different markets, Market Participants will purchase the Asset in a low – priced market, for re – sale in a high – priced market and make profit in this process. 3. Due to the operation of price Mechanism, the **price is driven up in the low – priced market and pushed down in the high – priced market**. 4. This activity will continue until the prices in the two markets are equalized, or until they differ only by the amount of transaction Costs involved in the operation. 5. There is potential for arbitrage in the Forex Market if exchange rates are not consistent between currencies. However, since **Forex Markets** are **highly integrated and efficient**, any Profit Spread on a given currency is quickly arbitraged away.

(5*1 = 5 MARKS)

ANSWER-C

Adverse selection is a situation in which asymmetric information about quality eliminates high-quality goods from a market. It a form of market failure which occurs when buyers have better information than sellers due to hidden information, and this can distort the usual market process. For example, in the insurance market adverse selection is the tendency for people with **higher risk to obtain insurance coverage to a greater extent** than persons with lesser risk because compared to insurance buyers, insurers know less about the health conditions of buyers and are therefore unable to differentiate between high-risk and low-risk persons. If the insurance company charges an average price, and only high – risk consumers buy insurance it will make losses. It is therefore possible that there will be higher overall premium as firms insure themselves against high-risk customers buying insurance. Then the low-risk customers may not want to buy insurance because it is quite expensive. Economic agents end up either **selecting a sub-standard product or leaving the market altogether leading to a condition of 'missing market'**. If the sellers wish to do business profitably, they may have to incur considerable costs in terms of time and money for identifying the extent of risk for different buyers.

(3 MARKS)

ANSWER-11

ANSWER-A

Aggregate demand is the total quantity of finished goods and services that all sectors (consumers, firms, government and the rest of the world) together wish to buy under different conditions. The components of aggregate demand are consumption demand, investment demand, government spending and net exports at each level of income. While **consumption demand is a function of the level of disposable income**, the demand for investment, government spending and net exports are autonomous, i.e. these are determined outside the model and are specifically assumed to be independent of income.

The Keynesian aggregate demand schedule is obtained by vertically adding the demand for consumption, investment demand, government spending and net exports at each level of income.

$$\mathbf{AD= C+ I+ G+ NX}$$

(3 MARKS)

ANSWER-B

Quasi-public goods or services, also called a near public good (for e.g. education, health services) possess nearly all the qualities of private goods and some of the benefits of public good. These goods are, in some measure excludable for example, it is possible to exclude non paying consumers from the use of a highway by incurring the cost of building and maintaining a toll booth. Similarly beaches, parks and wifi networks become partially rival and partially diminishable at times of peak demand. These are **rejectable** to some extent. It is possible 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. As such, people argue that these should not be left to the market alone. **Markets for the quasi-public goods are considered to be incomplete markets and their lack of provision by free markets would be considered as inefficiency and market failure**.

(2 MARKS)

ANSWER – C

	Market Stabilisation Scheme (MSS)	Open Market Operations (OMO)
Objective	It was introduced following MoU between RBI and the Government of India with the primary aim of aiding the Sterilization Operations of RBI.	The Objective of this operation is to adjust the Rupee Liquidity Conditions in the Market on a durable basis.
Process	Sterilization is the process by which the Monetary Authority (RBI) sterilizes the effects of significant foreign Capital Inflows on Domestic Liquidity, by off – loading a portion of the Stock of Government Securities held by it.	It is a Market Operation conducted by RBI by way of sale/ purchase of Government Securities to /from the Market.
Impact	Government borrows from RBI (additional to its Normal Borrowing) and issues Treasury Bills / Dated Securities for absorbing the excess liquidity from the Market arising from Large Capital Inflows.	During excess liquidity conditions, RBI sells Securities thereby sucking out the Liquidity. During tight Liquidity Conditions, it buys Securities thereby releasing Liquidity.

(3*1 = 3 MARKS)

ANSWER – D

Depreciation vs Devaluation :

	Depreciation	Devaluation
(a) Meaning	Depreciation is a **decrease in a Currency's Value** (relative to another currency) due to market forces in a Floating Exchange Rate Regime.	Devaluation is a **deliberate downward adjustment in the value of a Country's currency relative to another currency**, group of currencies or standard.
(b) Cause	Depreciation is **caused due to increase in Demand, with Supply remaining constant.**	Devaluation is **caused by the action of the Government /Central Bank / Monetary Authority policy actions**.
(c) Regime	Applicable for a Floating Exchange Rate Regime.	Applicable for a relatively Fixed Exchange Rate Regime.
(d) Scope	It is due to the interaction of market forces.	It is a monetary policy tool to make an official reduction in the par value of a currency.

Note : The terms "Appreciation" and "Revaluation" are used to denote the opposite of the above two terms "Depreciation" and "Devaluation" respectively. **(4*0.5 = 2 MARKS)**