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SUGGESTED SOLUTION

INTERMEDIATE M'19 EXAM

SUBJECT- ECONOMICS

Test Code – CIM 8155

BRANCH - () (Date :)

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ANSWER : 1

(A) Impact on Market Failure :

(2 Marks)

(a) Information Failure in **market exchanges leads to misallocation of scarce resource**. So, Equilibrium Price and Quantity is not established through the Price Mechanism. This results in Market Failure.

(b) Asymmetric Information, Adverse Selection and Moral Hazard affect the ability of Markets to efficiently allocate resources, and thus lead to Market Failure because the party with better information has a competitive advantage.

(B) There are three concepts of Terms of Trade (all expressed in Percentage), as under –

(3 Marks)

- **Net Barter Terms of Trade** → $\frac{Index\ of\ Export\ Prices}{Index\ of\ Import\ Prices}$
- Gross Barter Terms of Trade → $\frac{Index\ of\ Export\ Quantitites}{Index\ of\ Import\ Quantities}$
- Income Terms of Trade → $\frac{Index\ of\ Export\ Price\ \times Index\ of\ Export\ Qttys}{Index\ of\ Import\ Prices}$

Note : Terms of Trade depend on a number of factors including – (a) Elasticity of Demand and Supply, (b) Availability of substitutes, (c) Size of Demand, (d) Rate of Exchange, (e) Production Structure of a Country, etc.

(C) Concept : **(2 Marks)**

(a) 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

(b) In 1930s, Haberler refined the Comparative Cost Advantage Theory with the introduction of Opportunity Costs.

(c) Accordingly, each Country will specialize and export the Product in which it has lower Opportunity Costs.

(D) Budget : **(3 Marks)**

Point	**Description**
Meaning	1. The Budget is a **Statement of Revenues from Taxes & Other Sources (say, R), and Expenditures (say E) made by a nation's Government in a year.** 2. A Government's Budget can either be balanced, surplus or deficit. **Note : Balanced Budget (R = E) :** This Budget has no net effect on Aggregate Demand since the Leakages from the system (Taxes collected) are equal to the Injections (Govt. Expenditure).
Action during Recession	1. Government proposes a **Deficit Budget**. 2. **Deficit Budget (R < E) :** This budget has a positive net effect on Aggregate Demand since Injections exceed Leakages from the Government Sector. Consumption & Investment is enhanced. 3. Deficit Budget may be financed through – (a) Past Surpluses, if any, or (b)

	Government Borrowings, or (c) Monetization (i.e. creation of additional money to finance expenditure).
Action during Inflation	1. Government proposes a **Surplus Budget**. 2. **Surplus Budget (R > E) :** This Budget has a negative net effect on Aggregate Demand since Leakages exceed Injections. Disposable Income available for Consumption & Investment is reduced.

ANSWER : 2 **(5 Marks)**

(A) Govt. influences Resource Allocation by

	Govt. influences Resource Allocation by	Examples
Methods / Instruments of Govt. Intervention in Allocation	1. Direct Production of Goods	Electricity, Public Transportation Services
	2. Influence over Private Allocation through Incentives and Disincentives	Subsidies for Goods that promotes Social Welfare & High Taxes on goods like Cigarettes & Alcohol.
	3. Influence through Competition Policies, Merger Policies, etc. which affects the structure of industry & commerce	The Competition Act promotes competition, and prevents Anti – Competitive Activities.
	4. Regulatory Activities that influences Resource Allocation.	Licensing, Controls, Minimum Wages and Directives on Location of Industry.
	5. Legal & Administrative Frameworks	System of Penalties for non – compliance with law.

Note : any mix of the above or other Intermediate techniques may be adopted by Governments.

(B) Restrictions / Barriers : However, Government intervention in restricting free flow of goods and services is found in many forms in the practical world, which takes the form of Trade Barriers. The main purposes of imposing Trade Barriers are – **(5 Marks)**

(a) To **protect** Domestic Industries from Foreign competition,

(b) To **conserve** the Foreign Exchange Resources of the Country,

(c) To make the Balance of Payments Position **favourble**.

(d) To **curb** Conspicuous Consumption,

(e) To **mobilise** Revenue for the Government and,

(f) To **discriminate** against certain countries.

ANSWER : 3

(A) Depreciation vs Devaluation : **(5 Marks)**

	Depreciation	Devaluation
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.
Cause	Depreciation is caused due to increase in	Devaluation is caused by the action of

	Demand, with Supply remaining constant.	the Government /Central Bank / Monetary Authority policy actions.
Regime	Applicable for a **Floating Exchange Rate Regime.**	Applicable for a **relatively Fixed Exchange Rate Regime.**
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.

(B) Price Controls : (5 Marks)

(1) Some examples of Price controls are – (a) Minimum Wages, (b) Rent Controls, (c) Minimum Support Prices for Food grains, (d) Maximum Price above which certain Medicines cannot be sold. etc. –

(2) Price Controls may be – (a) Price Floor (i.e. a Minimum Price that Buyers are required to pay), or (b) **Price Ceiling** (i.e. a Maximum Price that Sellers are allowed to change for a good or service).

(3) In case of Primary Markets for Crops which are subject to wide price fluctuations, Government intervenes to manage Prices in many ways –

(a) Fixing Minimum Support Prices (MSP) in case of surplus crop production, to guarantee assured incomes to farmers, [Note: If Market Prices < MSP, then MSP will be paid to Farmers.]

(b) Setting Maximum Prices of Food grains during times of scarcity,

(c) Government Procurement and stocking of Food grains to stabilize prices and consumption.

ANSWER : 4

(A) Govt. Intervention to minimize Market Power (3 Marks)

Government Intervention to minimize Market Power is generally through Legislation and Regulations, as under –

- **Competition – based Regulations**

Government Prevents emergence of monopolies, and related Social Costs (higher prices, lower output, etc.), by –

1. Promoting competition,
2. Prohibiting contracts, combinations and agreements amongst Firms which are –(a) anti – competitive, (b) in restraints of trade, (c) detrimental to consumers, etc.
3. Ensuring proper use of Intellectual Property Rights, and avoiding their misuse, etc.

Example : Competition Law, Patents Law in India.

- **<u>Price – based Regulations</u>**

  Price – based Regulations include the following –

  1. Setting **<u>Maximum prices t</u>**hat Firms can charge, (e.g. Essential Drugs and similar items),
  2. Rate of Return Regulation, in which a Regulatory authority determines an acceptable price for an item, based on its Costs + Fair Rate of Return (e.g. for Natural Monopolies like Electricity, Gas, Water),
  3. Price – Caps based on a Firm's Variable Costs, Past Prices, possible inflation and productivity growth, etc.

(B) Negative Impact : **(2 Marks)**

However, Tariffs also have the following negative impact -

(a) reduction in consumer well – being, due to higher cost of imported goods,
(b) increases in Prices by Domestic Producers of same item, to match with high cost of imported goods,
(c) loss of output and employment in case of Sectors that are rendered redundant due to import of goods,
(d) creation of trade distortions, by encouraging inefficient production in Home Country, and discourage efficient production in the rest of the world.

(C) Crowding Out :

- **Meaning :**

  'Crowding out' effect is the **<u>negative effect fiscal policy</u>** 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.

(2 Marks)

(D) 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 – **(3 Marks)**

1. **<u>Enterpreneurship :</u>** World Markets are opening up due to **<u>lowering of tariffs</u>** and **<u>dismantling of other restrictions</u>** in developed and developing countries. Enlightened Entrepreneurs have opportunities to benefit from their comparative advantages. Entrepreneurial Ability (knowledge based) will come to force 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 bases 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 the 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 business.

ANSWER : 5

(A) Floating vs Fixed Exchange Rate Regimes : (4 Marks)

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 fluctuations 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	FX Rate keeps on changing based on	FX Rate generally remains stable and

Rate	market factors.	only a small variation is possible.

(B) Common Access Resources / Common Pool Resources : (4 Marks)

1. **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.

2. **Example :** Forest, Resources, Minerals, Oil and Natural Gas Deposits in Nature, Fisheries, Common Pastures, Rivers, Sea, Backwaters, Earth's Atmosphere, Public Roads, Public Parks, etc.

3. **Depletion / Quick Degradation :**

   (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.

   (b) This creates threat to the sustainability of these resources and, also the availability of common access resources for future generations.

   (c) This problem of overuse to the disadvantage of the entire world, is described by the term "Tragedy of the Commons".

(C)

Limitations of GATT: (2 Marks)

1. **Increase in the volume** and value of international trade, beyond the scope of GATT.
2. Opening up of economies, and free flow of capital investments – area not covered by GATT.
3. **Growth** in intellectual property rights(IPR) and services – areas not covered by GATT.
4. **Inadequacies** in the institutional structure , and dispute settlement mechanisms
5. **Inconsistency** between a country's domestic rules, and GATT – GATT not enforceable in this case
6. **Ambiguities** caused by regional trade agreements , regional trade blocks – question of superiority of GATT or RTAs, which is to be implemented etc.