INTER CA – MAY 2018

Sub: ECONOMICS (FULL PORTION)

Test Code – M28
Branch: MULTIPLE Date: 21.01.2018

(50 Marks)

*Note: **All** questions are compulsory.*

Question 1 (4 marks)

Benefits and costs of FDI to Host country

A. BENEFITS (1 mark for each point)

Perspective	Points
Business firms perspective	1. **competitive** environment due to entry of foreign firms, 2. cost- reducing and quality- improving **innovation**, 3. better access to foreign markets, due to competitive export price,
Customers perspective	4. increasing **variety** of better product and service, 5. **Lower prices** for wide range of products, and better welfare for consumer .
Micro-economic perspective	6. ability to finance **more investment** than what can be supported by domestic savings, 7. **Efficiency** of factors of production, due to increased capital to work. With labour and other rescues 8. **Faster Rate** of growth and economic development due to inflow of capital technical knowhow management skill, marketing skill, and human capital skill like management technical 9. **Multiplier Effect** on employment and income , due to increase in production base, and investment propelled in the downstream and upstream projects, 10. growth of **Ancillary Industries and Services Sector** (including tourism), due to opportunities create through backward and forward linkage, 11.**Higer wages** for skilled jobs, and indirect employment to unskilled person in lower and operation 12. Use id FDI capital to produce **goods for export**, leading to higher forex Inflows for host country , 13. higher direct and indirect **Tax Revenue** for government, due to increase in income and employment levels , as also in consumption 14. **Weakening** of domestic monopolies, thus leading to increase in output and fall in price, 15. Better **Balance of payments** position, since many product will be produce domestically with FDI, thus reducing the levels of imports,
Other / general	16. achievement of political refonns required to attract foreign investors, including legal system and macro-economic policies, 17. grater people to people relation , and higher dependence on international investors 18. better work culture, higher productivity standard, productivity related awareness, and thus overall human resources development.

Question 2 (4marks) (1 mark for each point)

Point	Description
Concept	1. GATT is a Multilateral Trade Agreement created in January 1948 to achieve a board, multilateral and free worldwide system of trading. 2. GATT provide the rules of International trade from 1948 to 1994 [WTO applicable from 1995 onwards]. 3. GATT governed International trade, working along with the World Bank & International Monetary Fund.

Principles	1. Member countries will consult each other concerning trade problems. 2. GATT provides a framework for negotiations in a legal environment. 3. Trade should be conducted on a non – discriminatory basis.
Objectives	1. To provide equal opportunities to all countries in international market for trading purpose. 2. To increase the effective global demand. 3. To ensure a better living standards in the world as a whole. 4. To provide amicable solution to the disputes related to international trade.
Rounds	1. Multilateral Negotiation Processes under GATT are called “Rounds” or “Trade Rounds”, and are named after the place where such discussion started, e.g. Tokyo Round, Uruguay Round, Doha Round etc. 2. These “Rounds” resulted in substantial international trade liberalisation, reduction in barriers, etc.
Loss of Relevance	GATT lost its relevance in mid 1980s, and the need for a new arrangement was felt, due to the following – 1. Increase in the volume and value of International Trade, beyond the scope of GATT, 2. Opening up of economics, and free flow of Capital Investments – area not covered by GATT, 3. Growth in Intellectual Property Rights (IPRs) and services – areas not covered by GATT, 4. Inadequacies in the Institutions 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.

Question 3 (4 marks) (1 mark for each point)

1. Approach: QTM is one of the oldest theories in Economics. It was first propounded by lrving Fisher in 1911. Fisher’s Version is also termed as ‘Equation of Exchange’ or ‘Transaction Approach’.

2. Concept: Demand for Money = Price Level (P) x Total Volume of Transactions (T) = Supply of Money (MV + MV).

3. Equation of Exchange:

Fisher’s Equation (with only Actual Money)	**MV = PT**	**Where** M = Total Amount of Money in circulation V = Transaction Velocity of Circulation **[Note a]** P = Average Price Level (P = $\frac{\mathrm{MV}}{\mathrm{T}}$) T = Total Number of Transactions **[Note b]** M’ = Total Quantity of Credit Money **[Note c]** V’ = Velocity of Circulation of Credit Money **[Note a]**
Fisher’s Extended Equation (with Actual and Credit Money)	**MV + M‘V’ = PT**	

Note:

(a) Velocity means Average Number of times across all transactions a Unit of Money (say Rupee) is spent in purchasing Goods and Services. Velocity of Money in Circulation (V) & Velocity of Credit Money (V’) remains constant.

(b) T is a function of National Income. Since full employment prevails, Volume of Transactions (T) is fixed in short run.

(c) Credit Money represents the Demand Deposits by Banks. M = Actual Money, M’ = Credit Money.

4. Explanation of Theory:

(a) There is strong relationship between Money and Price Level. So, Quantity of Money is the main determinant of the Price Level or the Value of Money.

(b) So, changes in the General Level of Commodity Prices / Value / Purchasing Power of Money are determined by changes in the Quantity of Money in Circulations.

(c) Higher the Number of transactions that people want, higher will be the Demand for Money. [Transaction Motive]

(d) Fisher did not specifically mention anything about the Demand for Money. However, the same is embedded in his Theory as dependent on the Total Value of Transactions undertaken in the economy.

Question 4 (4 marks)

1. Reserve Money: Reserve Money can be computed in two ways as under – [**Note:** Net Result is the same in both] **(2 marks)**

Method 1: Uses or Liability Approach	**Method 2: Sources** or Assets Approach
Currency in Circulation / held by the public **Add:** Banker's Deposits with the RBI [Note] **Note:** These are Commercial Banks' Deposits with RBI for maintaining Cash Reserve Ration (CRR) & as working Funds for clearing adjustments. **Add:** Other Deposits with the RBI	Net RBI Credit to Government **Add:** RBI Credit to the Commercial Sector **Add:** RBI's Claims on Banks **Add:** RBI's Net Foreign Assets **Add:** Government's Currency Liabilities to the Public Less: RBI's Net Non – Monetary Liabilities
Reserve Money	**Reserve Money**

Note: In the above Table, **Method 1** relates to the **Liabilities** of the RBI and **Method 2** relates to Assets of the RBI.

2. Significance of Reserve Money: (1 mark)

(a) Reserve Money is also known as Central Bank Money, Base Money or High – Powered Money.

(b) Reserve Money plays a critical role in the determination of the Total Supply of Money.

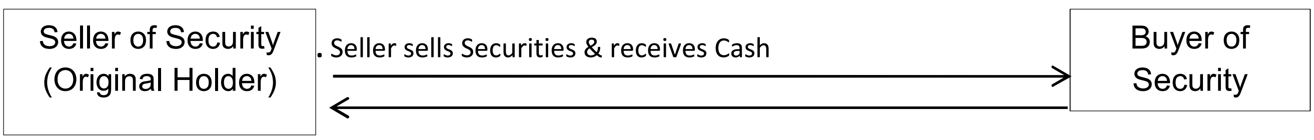
(c) Management of Reserve Money is important to stabilise Liquidity, Growth, and Price Level in an Economy.

3. Reserve Money VS Narrow Money: M1 includes Demand Deposits. Reserve Money includes Cash Reserve of Banks. **(1 mark)**

Currency held by the Public **Add:** Net Demand Deposits of Banks (CASA Deposits) **Add:** Other Deposits of the RBI	Currency held by the Public **Add:** Banker's Deposits with the RBI **Add:** Other Deposits with the RBI
Narrow Money = Least Liquid Money = M1	**Reserve Money**

Question 5 (4 marks) (1 mark for each point)

1. **Repurchase Transaction:** Repo is a Money Market Instrument, which enables Collateralized Short Term borrowing and lending through sale / purchase operations in Debt Instruments.



2. Seller re – purchases Securities and pays the amount originally received, plus the return on the money for the number of days for which the money was used, which is mutually agreed.

2. Repo vs Reverse Repo:

	Repurchase Transaction	**Reverse Repurchase (Reverse Repo)**
Meaning	Instrument for borrowing Funds by selling Securities with an agreement to re – purchase them on a mutually agreed future date at an agreed price which includes	Instrument for lending Funds by purchasing Securities with an agreement to resell them on a mutually agreed future date at an agreed price

	Interest for the Funds borrowed.	which includes Interest for the funds lent.
Process	Repo Operation takes place when other Banks borrow Money from RBI by giving Securities to the RBI.	Reverse Repo Operation takes place when RBI borrows Money from Banks by giving them Securities.
Impact	Repo Operations inject Liquidity into the system.	This Operation absorbs the Liquidity in the system.
Interest [Note]	Interest Rate charged by RBI for this transaction is called the 'Repo Rate'. Higher than Reverse Repo Rate.	Interest Rate paid by RBI for such transactions is called the 'Reverse Repo Rate'. Less than Repo Rate.
Presently	Repo Rate is 6.25%	Reverse Repo Rate is 6%

Note: MSF (6.5%) is the upper band of Interest Corridor. Repo Rate is at the middle & Reverse Repo at the lower band. MSF & Reverse Repo Rate determine the corridor for daily movement in the movement in Weighted Average Call Money Rate.

3. **Online System:** All these transactions are reported on the electronic platform called the Negotiated Dealing System (NDS). The Clearing Corporation of India Ltd. (CCIL)has put in an anonymous Online Repo Dealing System in India, with an anonymous order matching Electronic Platform.

4. **Eligible Securities:** The Securities transacted can be either Government Securities or Corporate Securities or any other Securities which the RBI permits for transaction. The Collaterals used for Repo and Reserve Repo Operations consists of primarily Government of India Dated Securities / Treasury Bills.

5. **Types of Repo Markets:** RBI also conducts variable Interest Rate Reverse Repo Auctions,as necessitated under the market conditions. There are three types of Repo Markets operating in India presently –
   (a) Repo on sovereign Securities,
   (b) Repo Corporate Debt Securities,
   (c) Other Repos.

Question 6 (5 marks)

Problems of Information Failure: The problems associated with Information Failure include the following –

Point	Description
Asymmetric Information (1 mark)	Asymmetric Information is where there is an imbalance in information between Buyer and Seller – (a) When the buyer knows more than the Seller (e.g. Traders having insider information), or (b) When the seller knows more than the buyer (e.g. Seller of Old Car knows more about its quality than the buyer).
Adverse Selection (2 mark)	1. Adverse Selection is a situation in which Asymmetric Information about quality eliminates high – quality goods from a market. **2. Example:** In the Used – Car Market, the car Owner/Seller knows about more about the quality of the Car than others. The Buyer's willingness to pay for any particular Car will be based on the "average quality" of used cars. An unusually poor car is referred as a "Lemon" in this regard. Anyone who sells a "Lemon" stands to gain. So, the market becomes flooded with Lemons. Eventually the Market may offer nothing but lemons. The good – quality cars disappear because they are kept by their Owners or sold only to friends. So, Buyers except hidden problems in items offered for sale, leading to low prices and the best items being kept off the market

Moral Hazard (2 mark)	1. Moral Hazard is opportunism characterized by an informed person's taking advantage of a less – informed person through an unobserved action. 2. Moral Hazard occurs when there is a distortion of incentives to take care or to exert effort when someone else bears the costs of the lack of care or effort. 3. Moral Hazard occurs when a party whose actions are unobserved can affect the probability or magnitude of a payment associated with an event. 4. When someone is protected from paying the full costs of their harmful actions, they tend to at irresponsibly, making the harmful consequences more likely. 5. Example: (a) Insured Consumers are likely to take greater risks, knowing that Claim will be paid for by the Insurance Company. (d) A person cares less about the Doctor charging excessive fees or using inefficient and costly procedures as part of his health care, since the costs are paid by the Insurance Company. [Note: This causes Insurance Premium to rise for all persons, sending many potential customers out of the market.]

Question 7 (5 marks) (2 ½ marks each)

A. **<u>Redistribution Function:</u>**

1. The distribution function of budget is related to a basic question from whom should an economy produce goods and services.
2. It mainly focuses on justice, equity & fairness.
3. Distribution function of the government aims at advancing well – being of those members of the society who suffer from absolute poverty.
4. Providing equality of income, wealth and opportunities and ensuring that everyone enjoys minimum standard of living.

Redistributing function performed by Govt. are as follows:

(i) Progressive taxation.
(ii) Financing public services that benefits law income households.
(iii) Employment reservation.
(iv) Regulation of the manufacture and sale of certain products to insure health and well – being of the consumers.
(v) Special schemes for backwards regions.

B.

Indirect / Market – based Controls over Negative Externalities: (1/2 mark for each point)

<u>Tradeable Emissions Permits, i.e. Cap-and-Trade</u>

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a) Marketable Licenses (called Permits) to emit limited quantities of Pollutants can be bought at a specified price from the Regulatory Agency, by Polluters.
b) Each Firm has Permits specifying the number of units of emissions that the Firm is allowed to generate.
c) These Permits are transferable. So, different pollution levels are possible across the regulated Entities.
d) A High Polluter has to either – (i) pay Monetary Penalties, or (ii) buy more Permits. Both leading to increase in costs, and decrease in profits.
e) A Low Polluter can – (i) avoid Monetary Penalties, and (ii) sell Permits and earn revenue, both making such Firm profitable.

Question 8 (5 marks) (1 mark for each point)

1. Expansionary Fiscal policy is defined as increase in Govt. expenditure or decrease in taxes that causes Govt's budget deficit to increase or its budget surplus to decrease.

Contractionary Fiscal policy is defined as decrease in Govt. expenditure or increase in taxes that causes Govt. budget deficit to decrease or its budget surplus to increase.

2. Expanisionary Fiscal policy is used to address recession and the problem of General unemployment due to business cycles.

   Contractionary Fiscal policy is used to address the problem of inflation due to extreme higher GDP growth.

3. Expansionary Fiscal policy refers to the deliberate policy of the Govt. applied to increase aggregate demand and simultaneously increase the level of economic activity.

   Contractionary Fiscal policy refers to the deliberate policy of the Govt. applied to curtail aggregate demand and simultaneously reduce the level of economic activity

4. Expansionary Fiscal policy is aimed at eliminating recessionary gap which is done by decreasing tax rates and increasing public expenditure

   Contractionary Fiscal policy is aimed at eliminating inflationary aggregate demand and reduce unemployment in the economy.

5. The aim of expansionary Fiscal policy is to increase aggregate demand and reduce unemployment in the economy.

   The aim of contractionary fiscal policy is to reduce aggregate demand which leads to reduction in employment generation.

Question 9 (5 marks) (2 ½ mark for each part)

Based on the concepts of "Domestic" and "National" measurements, as well as the concepts of "Market Prices" and "Factor Cost" given above, the following concepts of measurements arise –

	GDP at Factor Cost	**GNP at Factor Cost**
1. Meaning	GDP pc is the Total of Incomes of Factors of Production, i.e. Land, Labour, Capital and Entrepreneurship	GNP pc is the Total of Incomes of Factors of Production, i.e. Land, Labour, Capital and Entrepreneurship, adjusted for Net Factor Incomes from Abroad.
2. Formula (a) MP vs FC Route	GDPpc = GDPmp (-) Net Indirect Taxes	GNPpc = GNPmp (-) Net Indirect Taxes
3. Total Factor Cost Route	Compensation of Employees • Operating Surplus • Mixed Income of Self – Employed • Depreciation	Compensation of Employees • Operating Surplus • Mixed Income of Self – Employed • Depreciation • Net Factor Incomes from Aboard

Question 10 (5 marks)

Procedure income can be spent either on Consumer Goods or Investment Goods. So, the procedure is as under -

Step	**Description**
1.	Identify various head of consumption expenditure and investment, under the following categories (a) final consumption expenditure by – (1) households, (2) government (b) Gross domestic capital formation, (c) Net exports. ,i.e exports(-) imports **(**
2.	Compute GDA = I (Final Consumption Expenditure + Gross Domestic Capital Formation + Net Exports).
3.	Compute National Income (i.e. NNPpc) by the following computation procedures. (a) NDPmp = GDPmp (as per Step 2) (-) Depreciation. (b) NDPpc = NDPmp (as per Step 3a) (-) Net Indirect Taxes. (c) NNPpc (i.e. National Income) = NDPpc (as per Step 3b) (+) Net Factor Income form Aboard.

(2 mark)

Note: meaning of terms

Particulars	Meaning
Private final consumption expenditure	It is a total of what private individual / consumer households / not-for-profit entities that spend household, spend on consumption good & services, and includes- • Value of all final sales of goods & services at market price, • Value of primary produced for own consumption, • Payment for domestic services which one household renders to another, • Net expenditure on foreign financial assets, i.e. net foreign investment,
Government final consumption expenditure	• It is a total spending of the government on activities like defence, education , healthcare etc it is also referred to as 'government purchase' • Transfer payment like pension, scholarship, unemployment deles, are excluded
Gross domestic investment(of) gross domestic capital formation	It is the total expenditure towards investment goods , and includes- • Assets , machinery , equipment ,etc. purchased by business firm/ producing units, • Own account production of assets, machinery , equipment , etc. by producing units, • Expenditure on changes in inventories, • Land and residential buildings purchased / constructed by consumer household, • Expenditure on the acquisition of valuable by household , e.g. jewellery, etc .
Net exports (i.e. exports less imports)	• It is the total of what foreign countries spend on goods and services of the national economy over and above what this economy spends on the output of the foreign countries . • Net exports may be positive or negative, depending on consumption pattern.

(2 marks)

a. Advantages:

1. Most suited in situation where consumption pattern and expenditure data easlly available
2. Appropriate in sectors like construction, where this method used.
3. Most suitable in cases where commodity flow data capture , e.g. with implementation on GST.

b. Disadvantage:

1. it is difficult to measure capital formation (both domestic and foreign) in many situation.
2. it is may not be easy to differentiate between final consumption expenditure and capital formation in certain cases leading to double counting of the same expenditure . **(1 mark)**

Question 11 (5 marks)

1. In a Four Section Economy (Households, Business, Government and Foreign Sectors), we have the equation, Y = C + I + G + (X – M) = C + S + T, where

   C = Consumption, I = Investment, G – Govt. Spending, X = Exports, M = Imports, S = Savings and T = Taxes.

2. Here, on the Aggregate Demand side Y = C + I + G + (X = M).
3. Substituting the values, we have Y = 700 + 0.8Y + 1,200 + Nil + 100.

   On solving Y = 10,000.

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