SUGGESTED SOLUTION

SYJC

SUBJECT- ECONOMICS

Test Code – SYJ 6121 A

BRANCH - () (Date :)

Head Office : Shraddha, 3rd Floor, Near Chinai College, Andheri (E), Mumbai – 69.

Tel : (022) 26836666

ANSWER : 1

(A)
1. Price
2. Inelastic
3. Saving
4. Fixed
5. French

(5 MARKS)

(B)
1. - Substitute good
2. – Rent
3. - One year
4. - Apex banking institution
5. - Rightward shift in supply curve

(5 MARKS)

(C)
1. – True
2. – True
3. – False
4. – False
5. – True
6. – False

(6 MARKS)

ANSWER : 2(A)

(3* 2 = 6 MARKS)

1. **Partial equilibrium :**
   - **i.** Partial equilibrium is the technique used by microeconomics to study the equilibrium position of an individual economic unit.
   - **ii.** Partial equilibrium analysis assumes the condition of 'Ceteris Paribus', i.e. 'other things being constant'.
2. **Stock :**
   - **i.** Stock is the **<u>total quantity of a commodity available for sale</u>** with a seller at a particular point of time. It is potential supply.
   - **ii.** In the case of durable goods, the **<u>stock can exceed supply</u>**. In the case of perishable goods, the stock and supply can be the same.

3. **Price discrimination**
   - i. Price discrimination implies charging different prices for the same product to different buyer
   - ii. The monopolist adopts the technique of price discrimination for maximizing the profit.

4. **Capital**
   - **i.** According to Bohm Bawark, "Capital is a produced means of production." Capital refers to the stock of capital assets which yield income.
   - **ii.** Capital is a part of wealth.

5. **Macroeconomics**
   - i. The word macro is derived from the Greek word 'makros', meaning large or aggregate (total). Macroeconomics therefore is the study of aggregates covering the entire economy. It is also known as Theory of Income and Employment or simply as Income Analysis.

ii. In the words of Prof. Kenneth Boulding, "Macroeconomics deals not with individual quantities as such but with the aggregates of these quantities; not with the individual income, but with the national income; not with the individual prices but with the price level; not with individual output but with the national output."

6. **Cash Reserve Ratio**

   i. By the Banking Act, **commercial banks have to maintain a certain amount of cash with Central Bank (RBI)** as reserves against their demand and time deposits. Central Bank can vary CRR between 3 per cent to 15 per cent of total time and demand deposits.

   ii. **During inflation, the CRR is increased**. This decreases the credit creation capacity of commercial banks. **This ultimately reduces the money supply and inflation is controlled**. **During deflation, the CRR is decreased**. This increases the credit creation capacity of commercial banks. **This ultimately increases the money supply and deflation is controlled**.

ANSWER : 2(B)

(3* 2 = 6 MARKS)

1. The assumptions of microeconomics are unrealistic:

Ans.:

(1) Microeconomics assumes conditions of full employment, pure capitalism, laissez – faire policy of government, perfect competition, ceteris Paribus, etc. in an economy.

(2) But in reality, economy with such conditions does not exist. Therefore, the assumptions of microeconomics are unrealistic.

2. Utility is a psychological term

Ans.

(i) Utility is the feeling of a consumer towards a particular commodity.

(ii) Utility does not have physical existence. It is abstract in nature. Therefore, utility is a psychological concept.

3. All desires are not demand

Ans.:

(i) Desire means an individual's wish to acquire a commodity. On the other hand, a desire which is backed by ability to pay as well as willingness to pay for a commodity is demand. Symbolically, Demand = Desire + Ability to pay + Willingness to pay.

(ii) All desire may not be backed by ability to pay and willingness to pay. Therefore, all desires are not demand.

4. National income at factor cost includes subsidy

(1) **Ans.:** The amount of subsidy given by government gets distributed in the incomes of factors of production.

(2) National income at factor cost is the sum of all incomes of factors of production. Therefore, national income at factor cost includes subsidy.

5. Savings may be used in future for unseen contingencies

(1) Generally, people do not use the their entire income for consumption. They save a part of their income as a precaution against contingencies.

(2) The amount saved can be utilized to face unexpected expenditures due to sickness, accidents, etc.

Thus, saving may be used in future for unseen contingencies.

6. **The cash Reserve Ratio affects the lending capacity of commercial banks**.

(i) By the Banking Act, commercial Banks have to maintain a certain per cent (3 percent to 15 per cent) of cash with Central Bank (RBI) as reserves against their demand and time deposits. This amount cannot be used by banks for lending activities.

(ii) If the CRR is increased the amount available for lending gets reduced and vice versa.

Thus, the CRR affects the lending capacity of the banks.

ANSWER : 3 (A)

(3* 2 = 6 MARKS)

1. **Contraction in demand and Expansion in demand**

Points	Contraction in Demand	Expansion in Demand
Meaning	Other factors remaining constant, a fall in demand due to a rise in price is called contraction in demand.	Other factors remaining constant, a rise in demand due to a fall in price is called expansion in demand.
Movement in equilibrium point	In contraction in demand equilibrium point of price and demand moves upward from the right to the left on the same demand curve.	In expansion in demand equilibrium point of price and demand moves downward from the left to the right on the same demand curve.

2. **Perfectly elastic demand and Perfectly inelastic demand**

Points	Perfectly elastic demand	Perfectly inelastic demand
Meaning	When a single proportionate change in the price of a commodity brings an infinite (unlimited) proportionate change in its quantity demanded, the demand is said to be perfectly elastic.	When the proportionate change in the price of a commodity brings no (Zero) proportionate change in its quantity demanded, the demand is said to be perfectly inelastic.
Numerical Value	In the case of perfectly elastic demand, the numerical value of the elasticity of demand is infinite.	In the case of perfectly inelastic demand , the numerical value of the elasticity of demand is zero.

3. **Partial equilibrium and General equilibrium**

Point	Partial Equilibrium	General equilibrium
1. Meaning	Partial equilibrium is a type of equilibrium used in microeconomics, which explains the equilibrium of a particular unit of an economy.	General equilibrium is a type of equilibrium used in macroeconomics, which explains the equilibrium of the entire economy.
2. Nature	Partial equilibrium neglects the functional relationship and interdependence between the economic variables by assuming 'other things being constant'.	General equilibrium assumes the functional relationship and interdependence between the economic variables by assuming 'everything depends on everything else.'

4. **Net National Product and Net Domestic Product**

Point	Net National Product	Net Domestic Product
1. Meaning	Net National Product is the net value of all final goods and services produced by the residents of a country during a period of one year.	Net Domestic Product is the net value of all final goods and services produced within the territorial boundaries of a country during a period of one year.
2. Formula	NNP = C + I + G + (X – M) + (R – P) – D	NDP = C + I + G + (X – M) – D

5. Commodity money and Metallic money

Point	Commodity money	Metallic money
1. Meaning	Money accepted in the form of commodities such as cattle, feathers, tusks, animal skin, salt, shells, etc. is called commodity money.	Money made out of metals such as gold, silver, aluminium, nickel is called metallic coins (money).
2. Use	Commodity money was in use before metallic money.	Metallic money came in use as a replacement of commodity money.

6. Deficit budget and Balanced budget

Point	Deficit Budget	Balanced Budget
1. Meaning	A budget in which government's anticipated expenditure exceeds its estimated revenue is called deficit budget.	A budget in which government's estimated revenue and its anticipated expenditure is equal is called balance budget.
2. Use	Deficit budget is used during depression to increase the effective demand and the employment level.	In modern times, a balanced budget is only a theoretical concept. It has no practical use in changing economic conditions.

ANSWER : 3(B) **(2* 3 = 6 MARKS)**

1. Subject matter of microeconomics.

- The scope and subject matter of microeconomics is mainly confined to price theory and resource allocation.
- Microeconomics explains how the prices of a variety of goods and services are determined by the equilibrium of their demand and supply forces.
- Microeconomics also explain how the prices of factors of production, viz. land, labour, capital and entrepreneur are determined by the equilibrium of their demand and supply forces.
- Microeconomics also includes the theory of welfare in its scope, Microeconomics studies efficiency in production, efficiency in consumption and efficiency in the direction of production i.e. overall economic efficiency.

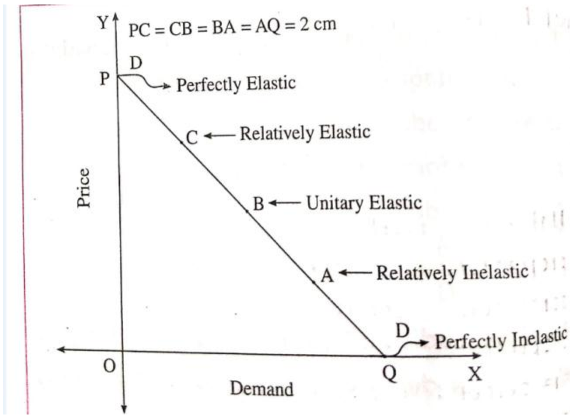
Microeconomics does not study the aggregates of an economy. Therefore the scope and subject matter of microeconomics is comparatively limited and narrow.

2. Geometrical method of measuring elasticity of demand

(1) Geometric method of measuring elasticity of demand is also developed by D. Alfred Marshall. This method is also known as point method of measuring elasticity of demand.

(2) This method is used to find out the elasticity of demand at any given point on a demand curve.

(3) For measuring the elasticity of demand at a given point on the linear demand curve, the linear demand curve can be extended to meet the Y – axis at P and X – axis at Q as follows :



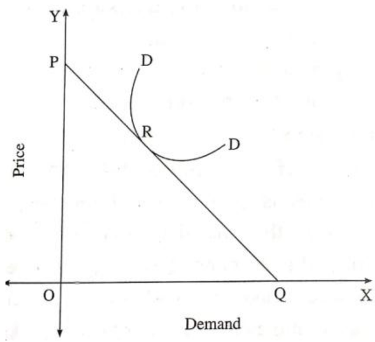
The price elasticity of demand at a point 'A' can be calculated with the help of the following formula:

$$E_d = \frac{Lower\ segment\ of\ the\ demand\ curve\ below\ the\ given\ point}{Upper\ segment\ of\ the\ demand\ curve\ above\ the\ given\ point}$$

$$E_d = \frac{AQ}{AP} = \frac{2}{6} = 0.33$$

At point 'A' the numerical value of elasticity of demand is less than one (E_d = 0.33). Therefore at point 'a' the demand is relatively inelastic.

(4) For measuring the elasticity of demand at a given point on the non – linear demand curve, tangent from a given point touching the Y – axis and X – axis is drawn as follows : RQ = 6 cm, RP = 2 cm



The price elasticity of demand at a point 'R' can be calculated with the help of the following formula :

$$E_d = \frac{Lower\ segment\ of\ the\ tangetn\ below\ the\ given\ point}{Upper\ segment\ of\ the\ tangent\ below\ the\ given\ point}$$

$$E_d = \frac{RQ}{RP} = \frac{6}{2} = 3$$

At point 'R' the numerical value of elasticity of demand is greater than one.($E_{d\ =\ 3)}$ Therefore at point 'R' the demand is relatively elastic.

3. **Qualities of entrepreneur**

(1) **Efficient :** Entrepreneur should be highly intelligent, able and efficient so as to solve the problems arising in industry.
(2) **Organizer :** Entrepreneur should be a good organizer. He should have the ability to combine and co – ordinate the factors of production, viz. land, labour and capital in an appropriate manner.
(3) **Leadership :** Entrepreneur should possess the quality of leadership. The key to successful business is brilliant leadership. Entrepreneur should put the right person to the right job. He should give right direction to different factors of production.
(4) **Decision maker :** Entrepreneur should be a quick decision maker. He should have the capacity to take quick decisions regarding the location of industry, investment, nature of product, sale of the products, etc.
(5) **Self – confident :** Entrepreneur should be self confident and should be able to develop confidence in others, regarding his integrity and honesty. This helps to maintain goodwill and reputation of his firm in the market.
(6) **Bold and courageous :** Entrepreneur should be capable to face and correct the difficulties and adverse circumstances with confidence.
(7) **Knowledgeable :** Entrepreneur should have complete knowledge about his business, market conditions, new technology, ups and downs in the market. Etc.
(8) **Innovator :** Entrepreneur should be a good innovator. He should introduce new technique of production which minimizes the cost of product. He should find new market for his product. He should also find out new sales promotion techniques.
(9) **Vision and foresight :** Entrepreneur should be a person who has vision, foresight and a drive to move ahead of others. He must be a man with imagination and judgment so that he may be able to foresee the changes that are likely to take place in the market trends.

4. **Features of pure competition.**

(1) **Large number of sellers :** In pure competition, there is a large number of potential sellers selling their commodity in the market. Their number is so large that a single seller cannot influence the market price.

(2) **Large number of buyers :** In pure competition, there is a large number of potential buyers buying commodity in the market. Their number is so large that a single buyer cannot influence the market price.

(3) **Free entry and exit :** In pure competition, any firm can freely enter or can take exist from the market without any restrictions.

(4) **Homogeneous product :** In pure competition, every firm produces and sells identical products, i.e. units of a commodity produced by each firm are uniform in respect of size shape, colour, quality, etc. Therefore the commodities sold in pure market are perfect substitutes to one another.

ANSWER : 4 **(3* 4 = 12 MARKS)**

1. **Assumption of the law of diminishing Marginal Utility**

(1) Homogeneity – the law assumes that units of a commodity consumed by a consumer are uniform. They are identical or same in case of size, colour, shape, taste, quality, etc.

(2) Single use – Utility is multi – purpose for some goods which satisfy variety of wants. Here, it is assumed that a commodity is used to satisfy only a single want to experience the law.

(3) Cardinal measurement – Utility can be measured in numbers. So that, it is possible to know and compare utility derived from each unit of a commodity, It helps to understand the law.

(4) Rationality – A consumer is assumed to be a rational person and his behavior is normal and therefore, he tries to maximize his satisfaction.

(5) Continuity – The units of a commodity are consumed in quick succession, one after another. MU will not diminish, if there is time interval.

(6) Reasonability – The units of commodity consumed, should be of a standard or normal size. They should neither be too big nor too small. e.g. a cup of tea, a glass of water, etc.

(7) Constancy – Income, taste, habits, liking, etc., of a consumer and price of a commodity remain constant throughout the period of consumption. It also assumes that MU of each unit of money remains constant.

(8) Condition of divisibility – The law assumes that eh commodity consumed by the consumer is divisible so that it can be acquired in small quantities for quick consumption.

The law holds true only, if the above given assumptions are fulfilled.

2. Important features of monopoly.

(1) Single seller : In a monopoly market there is a single seller or a single producer. Under monopoly, the monopolist has no rivals and therefore he faces no competition.

(2) No close substitute : There are no close substitutes for the commodity sold in the monopoly market. Therefore a monopolist faces no competition.

(3) Barriers to entry : Under monopoly, the entry of other firm is strictly restricted. The monopolist has complete hold over the supply in the market. Such a provision protects monopoly powers.

(4) No distinction between firm and the industry : Under monopoly there is only one seller. Therefore, there is no distinction between the firm and the industry. Under monopoly, the firm itself becomes the industry of a product.

(5) Control over the market supply : The monopolist has the complete hold over the market supply as he is a sole producer to the commodity. In monopoly, many entry barriers such as natural, economic, technological or legal do not allow competitors to enter the market.

(6) Price maker : The firm under monopoly is a price maker and not a price taker. Monopolist can set any price of the commodity as he has complete control over the supply of the product.

(7) Super normal profit : The monopolist always wants to earn supernormal profit. His decision regarding the price and the level of output are guided by the profit maximization motive. Thus, sometimes at higher price he supplies the product as per the demand and sometimes he controls the supply of the product and sells the product at high price.

(8) **Price discrimination :** Price discrimination implies charging different prices for the same product to different buyers. The monopolist succeeds in increasing his profit by adopting the technique of price discrimination.

3. Subject matter of macroeconomics :

(1) Theory of Income and Employment :

Macroeconomics analysis explains how the level of national income and employment is determined. To understand the determination of the level of income and employment, it also studies the determinants of aggregate supply, aggregate demand, consumption function, investment function and business cycles. Macroeconomics also examines interrelation between income and employment, causes for fluctuations in income and employment and suggests policies to solve the problems related to these variables.

(2) Theory of General Price level and inflation :

Macroeconomic analysis shows how the general level of prices is determined and further explains what causes fluctuations in it. Theory of price level studies the causes and effect of inflation and depression and suggests economic policies to tackle these problems.

(3) Theory of Growth and Development :

Macroeconomics studies the causes of under development and poverty in poor countries and suggests strategies for accelerating growth and development in them. Growth theory also deals with the problems related to full utilization of increasing productive capacity in developed countries. It also explains how the higher rate of growth with stability can be achieved in these countries.

(4) Macro theory of distribution : Macroeconomics explains the determination of the relative shares from the total national income of the various classes, especially workers and capitalists. Ricardo and Karl Marx propounded theories explaining the determination of relative shares of various social classes in the total national Income. Afterwards, Kalecki and Kaldor also explained determination of relative shares of wages and profits in the national income. Macro theory of distribution thus deals with the relative shares of rent, wages, interest and profits in the total national income. Study of public finance, international trade, monetary and fiscal policies are also a subject matter of macroeconomics.

4. The determinants of aggregate demand are symbolically expressed as follows :

AD = C + I + G + (x – M)
AD = Aggregate demand
C = consumption expenditure
I = Investment expenditure
G = Government expenditure
X – M = Net earnings from foreign transactions
Where X = exports, and M = imports

1. Consumption Expenditure : (C)

Consumption expenditure refer to the expenditure incurred for those goods and services which satisfy the wants of private individuals and institutions directly. For example, expenditure for food, clothes, houses, motor cars, education, health services, milk, vegetables etc.

The consumption expenditure may be partly autonomous and partly induced as shown below.

C = a + b where,
C = Consumption expenditure
a = Autonomous consumption expenditure
b = Induced consumption expenditure

Autonomous consumption expenditure refers to the expenditure, which is independent of income.

That is, it is expenditure irrespective of the size of income. It is income inelastic. In order to sustain life, every individual rich or poor, must have minimum of food, water, clothing and shelter. Without these minimum essential things to sustain life, no individual will be alive. In case of India, there are millions of people who do not have any type of job, and therefore absolutely no source of income.

The above type of consumption expenditure is not dependent on people’s income. Such consumption expenditure is , therefore, called ‘autonomous’ consumption expenditure. It should be noted that even this type of autonomous consumption expenditure shows demand for these types of goods and services.

Induced Consumption expenditure, refers to the expenditure directly related to the income. Higher the income, greater is the volume of consumption expenditure and lesser the income smaller is the volume of consumption expenditure.

2. Investment Expenditure (I)

Investment in economics means an addition to the country’s physical stock of capital, like new factory buildings, plant and machinery, tools, equipment’s, raw materials, as well as finished and semi – finished goods. It is also known as capital formation.

Saving is the starting point of capital formation because savings are used for investing into new capital assets.

According to Lord Keynes, the demand or volume of investment undertaken by private entrepreneurs in an economy depends on –

(1) Marginal Efficiency of Capital (MEC) or Marginal of Investment (MEI) – MEC is the expected rate of return from an additional unit of capital good invested.

(2) Rate of Interest : It is the cost of borrowing funds for investments. There is an inverse relationship between rate of interest and investment demand. An increase in the rate of interest, reduces the profitability resulting in a fall in investment demand and decrease in rate of interest will increase profitability & investment demand.
Any businessman will put his money in business only if the rate of return on his investment (M.E.C.) is greater than the market rate of interest. In other words a businessman will consider an investment worthwhile if –

MEC or MEI > Market rate of interest. If MEC < Market rate of interest, he will not invest.

Thus, higher the MEC or expected rate of return, higher will be the investment in the private sector economy. This higher investment will result in more employment, more production and more income generation in the economy.

5. Loans :

Loans can be classified into call loans, short – term loans, medium term loan sand long – term loans.

(1) Call Loans / Money at Call Notice :

Loans provided by commercial banks for a period of 7 to 15 days are known as call loan. These loans are taken by bill brokers or stock – brokers. The rate of interest is the lowest. These loans can be called back any time by the commercial banks from the borrowers.

(2) Short term Loans :

Short – term loans are provided by commercial banks for the period of not more than two years. The rate of interest is higher than call loans and lower than medium term loans. It is required by manufacturers and producers in order to fulfill their requirements of working capital.

(3) Medium term Loans :

Medium term loans are provided by commercial banks for the period from 2 years up to 5 years. The rate of interest charged by commercial banks is higher than the short term loans and lower than the long term loans. It is required by producers and manufactures for making changes in the methods of production, purchase of equipment, tools etc.

(4) Long term Loans :

When commercial banks give loans for a period of more than 5 years they are referred as long term loans. The rate of interest charged by the commercial banks is highest as compared to other types of loans. It is required by producers for making permanent changes in the methods of production, technique of production etc.

6. Types of Government Budget

In a modern society and, especially, in a welfare state, the activities of the government are fast expanding, and they are tending to cover almost all aspects of the social and economic life of the nation. Government is now an agency for promoting the general welfare of he citizens by positive acts. Government budgeting is one of the major processes, by which the use of the public resources are planned and controlled to attain certain objectives. Budgetary actions of the government affect production, size and distribution of income and utilization of human and material resource of the country.

So, the government should prepare different budgets for various situations in the economy. Public expenditure should be varied according to the requirement and urgencies of the business situation. Accordingly, government budget is of three types.

(1) Balanced budget
(2) Surplus budget
(3) Deficit budget

(1) Balance Budget : A government budget is said to be balanced when estimated revenue and expenditure are equal. That is, Government Receipts = government Expenditure. It implies that the government raises funds in the form of taxes and others means. A balanced budget was considered an effective check on extravagant expenditure of the government.
Government must exercise financial discipline and should keep its expenditure within the available income.

The concept of balanced budget has been evocated by classical economists like Adam Smith. A balanced budget was considered by them as neutral in its effect on the working of the economy and, hence, they regarded it as the best.

However, modern economists believe that the policy of balanced budget may not always be suitable for the economy. For instance, during the period of depression, when economic activities are at a low level, resulting in unemployment, the government may come to the rescue of the people. It can borrow money and spend it on public works. This will increase employment and total demand for goods and services and encourage investment.

(2) Surplus Budget : When estimated government receipts are more than the estimated government expenditure it is termed as Surplus Budget. When government spends less than the receipts the budget become surplus. That is,

Estimated government receipts > anticipated Government expenditure.

A surplus budget is used either to reduce governments public debt (its liabilities) or increase its savings.

A surplus budget may prove useful during the period of inflation. In periods of inflation, although there is greater employment, there is also a tendency for prices to rise rapidly. This has to be checked, particularly in the interest of those who have a more or less fixed income. This inflationary gap can be corrected by lowering the level of effective demand in the economy. It can be corrected by increasing taxes. This would increase the revenue of the government; but reduce the purchasing power of the people. As a result, the aggregate demand will fall. This inflationary gap can be corrected by lowering the level of public expenditure.

When government reduces its expenditure on public works and other infrastructure, the revenue with the government is in excess of its expenditure.

The surplus budget should not be used in situation other than the inflationary gap, as it may lead to unemployment and low levels of output in an economy.

(3) Deficit Budget :

When estimated government receipts are less than the estimated government expenditure, then the budget is termed as Deficit Budget. In modern economies most of the budgets are of this nature. That is,

Estimated Government Receipts < anticipated Government Expenditure

A deficit budget increases the liability of the government or decrease its reserves.

A deficit budget may prove useful during the period of depression. During the period of depression, economic activities are at low level. It results in unemployment, business losses etc. The government can borrow money and increase the expenditure on public works, through deficit financing. This will increase employment, and total effective demand for goods and services which would then encourage investment. Thus, a deficit budget is useful for removing depression and unemployment.

ANSWER : 5 **(3* 4 = 12 MARKS)**

1. There are no real exceptions for law of DMU. In the following some cases it is considered that the law of DMU is not valid :

(1) Hobbies (rate collection) : In certain hobbies like collection of stamps, rare coins, precious paintings etc. the law is not applicable because every additional increase in stock gives more pleasure, which increases MU. But in violates homogeneity condition.

(2) Misers : In case of miser, every additional rupee gives him more and more satisfaction, because he is a irrational person. So his MU tends to increase with an increase in the stock of money. However, it ignores rationality assumption.

(3) Drunkards : It is said that, in case of drunkards, the level of intoxication increases with every additional quantity of liquor consumed. So MU received by drunkards may increase. This condition is similar to all addicts. But here, rationality condition is violated.

(4) Music : Some people are fond of music. It is experienced that, a repeated of hearing of music, gives more and more satisfaction. It increases MU of music. SO the law is not applicable. However, it does not fulfill the assumptions like homogeneity and continuity.

(5) Reading : Since, more reading gives deeper knowledge, a scholar may receive more and more satisfaction, when he reads various books again and again, and therefore Marginal Utility tends to increase. But, here homogeneity and continuity conditions are not satisfied.

(6) Money : It is observed that MU of money never becomes zero. It increases when the stock of money increases. It is because money is a medium of exchange is used to purchase various goods and services to satisfy various wants. Therefore the law is not applicable in case of money.

Thus, in fact there are no real exceptions to the law of DMU. It has universal applicability.

2. **Price is the only determinant of demand.**

No, I do not agree with this statement.

The determinants of market demand are as follows :

(1) Price : Price is one of the most important factors that affect market demand. Usually, larger quantity is demanded at a lower price and vice versa.

(2) Income : Income is yet another important factor that affects market demand. Income and demand are directly related to each other. Normally, demand rises with increasing income and vice versa.

(3) Population : Demand for various goods and services get affected by the size as well as the composition of population. An increase in population leads to an increase in market demand for a variety of goods and services.

(4) Tastes, Habits and Fashion : Some factors such as taste, habit of consumers, etc. also determine the market demand. For example, an increased liking for cold drinks, ice – creams, etc. increases their demand.

(5) **Prices of Substitutes :** Market demand also gets influenced by the prices of substitutes. If a substitute is available at a lower price, people demand the substitute good in greater quantities than the commodity in question. For example, if the price of tea falls, market demand for coffee tends to fall.

(6) **Prices of Complementary Goods :** Market demand also gets affected by the prices of complementary goods. If the price of a complementary goods rises, the demand of the commodity in question tends to fall. For example, if the price of petrol rises, market demand for cars tends to fall.

(7) **Distribution of income :** Market demand for various goods and services gets influenced by the distribution of national income. Unequal distribution of income and wealth leads to fall in market demand and vice versa.

(8) **Expectations about future prices :** Expectations about future prices also determines the market demand. For example, if consumers expect fall in the price of a particular commodity in the near future, they will demand less quantities of such commodity though its present price is comparatively less and vice versa.

(9) **Advertisements :** Nowadays**,** the market demand for goods and services gets highly influenced by advertisements and other promotional activities. For example, the goods which are advertised powerfully on radio, television and newspapers, etc. are demanded in greater quantities.

(10) **Taxation policy :** Government's taxation policy also affects demand. For example, a rise in tax level reduces the consumer's disposable income and it in turn decreases the demand for different goods and services and vice versa.

3. **Yes, I agree** with this statement

(1) Labour supply : In the initial stages, Labour supply increases as wage rate increases. However, at a later stage, workers would prefer leisure to work. They Prefer to earn same amount of income by working less hours. Therefore, in the initial stages the labour supply curve slopes upwards from the left to the right. However, in the later stage, the labour supply curve bends backward.

4. **Yes, I agree** with this statement.

Reasons :

(1) Money performs primary functions as a medium of exchange and a measure of value.

(2) It performs secondary functions of standard of deferred payments, store of value and transfer of value.

(3) It also performs contingent functions of measuring and dividing of national income, providing basis of credit, imparting liquidity to wealth, equalizing marginal utilizes and marginal productivities with price and estimating macroeconomic variables.

(4) Similarly, money also helps in maintaining the repaying capacity, satisfying any want as per the priority and solving economic problems related to production and distribution.
Thus, money performs various functions.

5. **Yes, I agree** with this statement.

Reasons :

(1) Primary deposits refer to money deposited by the people in the form of cash with the banks. By keeping some part of primary deposits in the form of cash reserve, the rest of the primary deposits are used for lending loans.

(2) When a bank grants loans to a borrower, the bank opens a deposit account in the name of the borrower and the money transferred on the account of the borrower creates secondary deposits.

(3) When the borrower withdraws money from his loan account by a cheque, it is deposited by the payee in some other bank.

(4) Other banks again create credit on the basis of fresh deposits received after keeping the required reserves.

Thus, a commercial bank can create credit on the basis of primary deposits

6. **Yes I agree with this statement**

As a banker to all other banks, the central Bank performs the functions such as : (1) Acting as a custodian of cash reserves of commercial banks. (2) Acting as a clearing house for commercial banks .(3) Advising commercial banks if their activities are harmful to commercial banking. (4) Acting as a lender of the last resort.

ANSWER : 6 **(2* 8 = 16 MARKS)**

1.

Ans.

- **Introduction :**

Law of demand is one of the important basis laws of consumption. Prof. Alfred Marshall, in his book “Principles of Economics”, has explained the law of demand as follows

- **Statement of law**

“Other things being constant the higher the price of the commodity, smaller is the quantity demanded and lower the price of the commodity larger is the quantity demanded.”

The law of demand explains change in the bahaviour of consumer demand due to various changes in price. Marshall’s Law of demand describes functional relation between demand and price. It can be expressed as D = f(P) that is demand is function of price. The relation between price and demand is inverse, because larger quantity is demanded when price falls and smaller quantity will be demanded when price rises. The law of demand is explained with the help of the following schedule and diagram.

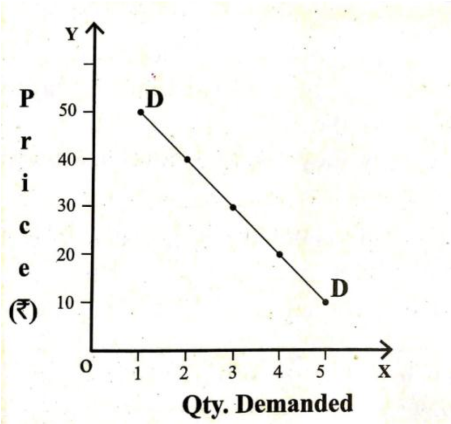
Demand Schedule

Price of Mangoes Per Kg. (Rs.)	Demand for Mangoes (Kg.)
50	1
40	2
30	3
20	4
10	5

As shown in the schedule when price of mangoes is Rs. 50/- per kg. demand is 1 kg. When price falls to the level of Rs. 40/- per kg. and demand rises to 2 kg. Similarly, at the price Rs. 10/- per kg. demand of mangoes is 5 kg., whereas 4 kg. of mangoes are demanded at price Rs. 20/- per kg. This shows inverse relation between price and demand.

In this diagram X axis represents demand for mangoes, whereas Y axis represents price of mangoes. DD is demand curve which slopes downwards from left to right. In other words, its slope is negative because of inverse relationship between price and demand.

Demand Curve

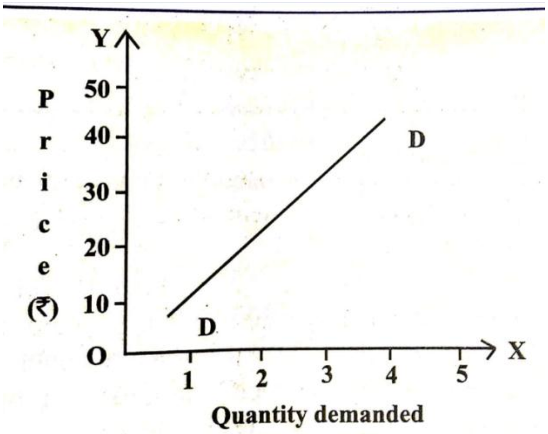


Exceptions to the Law of Demand

The Law of Demand explains an inverse relationship between the price of a commodity and the quantity demanded. Sometimes however we see a direct relationship between price and quantity demanded of a commodity.

Under exceptions to the Law of Demand, the demand curve slopes upwards from left to right which shows a direct relationship between price and quantity demanded. It can be shown in the following diagram.

Exceptional Demand Curve



Following are the exceptions to the Law of Demand.

(1) Giffen goods : Certain inferior goods are called Giffen goods, when the price falls, quite often less quantity will be purchased than before because of the negative income effect and people's increasing preference for a superior commodity with the rise in their real income. Sir Robert Giffen observed the situation relation to demand for bread & meat in England. When price of bread was decreasing, less bread was purchased. Here surplus money was transferred to purchase meat, as a result demand for meat increased.

This behavior is known as Giffen's paradox. Thus Giffen goods are inferior goods which have a direct relationship between price and quantity demanded. In this case the demand curve slopes upwards from left to right as shown in the above diagram.

(2) **Prestige goods :** Diamonds, high priced motor cars, luxurious bungalows are prestige goods. Such goods have a "snob appeal". Rich people consume such goods as status symbol. Therefore, when the price of such goods rises their demand also rises.

(3) **Price illusions or Consumers Psychological bias :** Consumers have illusion that high priced goods are of a better quality. Therefore the demand for such goods tends to increase with a rise in their price. E.g. Branded products which are expensive are demanded at a high price.

(4) **Demonstration effect :** The tendency of low income group to imitate the consumption pattern of high income groups is known as Demonstration effect. For example demand for consumer durables such as washing machine, latest mobile etc.

(5) **Ignorance :** Sometimes people do not have proper market knowledge. They may not be aware of the fall in price of a commodity and thus they tend to purchase more at a higher price.

(6) **Speculation :** When people speculate a change in price of a commodity in the future, they may not act according to the Law of demand. People may tend to buy more at rising price, when they anticipate further price rise. For example, in the stock market people tend to buy more shares at rising prices. Even if prices of some goods like sugar, oil etc. are rising before Diwali, people go on purchasing more of these things at rising prices, because they think that prices of these goods may increase further during Diwali.

(7) **Habitual Goods :** Due to habit of consumption certain goods like tobacco, cigarettes etc. are purchased even if prices are rising. Thus it is an exception.

2. Following are the factors which influence Elasticity of Demand

1. Nature of Commodities : Commodities may be either necessaries or luxuries. Normally, elasticity of demand for necessaries in inelastic and for luxuries demand is elastic.
2. Durability : The demand for durable goods is elastic, whereas the demand for perishable goods is inelastic.
3. Substitute Goods : Availability of substitutes also determine Elasticity of Demand. The larger the number of substitutes for a commodity in the market, greater will be the elasticity of demand
4. Uses of a commodity : When commodity can be put to several uses, its demand is elastic. The demand for electricity is elastic.
5. Price : Goods, which have very highly price or very low price have inelastic demand.
6. Habits : Habits influence Elasticity of Demand. The demand for goods which satisfy the habits, is normally inelastic. For instance, the demand for cigarettes is inelastic. Also consumption of essential goods cannot be postponed therefore demand for them is inelastic.
7. Income of Consumer : When income level is high demand is normally inelastic, and demand is elastic at a very low level of income.
8. Proportion of Expenditure : Generally when proportion of income spent on a commodity is large, demand for goods tend to be inelastic. For instance for good grains is inelastic.

9. Complementary Goods : By and large, demand for complementary goods is inelastic. Because complementary goods such as motor car and petrol are demanded jointly.

3. Measuring national income

(1) **Transfer payments:** Retired people gets pension. Unemployed people get unemployment allowance. Though pension, unemployment allowances, etc. is considered as an individual's income, it is not an earned income. Individual receives this income from government's expenditure. Therefore, it becomes difficult to decide whether or not to include such income in national income. Generally, transfer payments are ignored from national income.

(2) **Income of foreign firms:** According to International Monetary Fund's view point, income of a foreign firm should be included in national income of the country, where the firm actually undertakes production work. However, profits earned by foreign firms are credited to their home country. Therefore, it becomes difficult to decide whether or not to include the income of foreign firms in the national income.

(3) **Unpaid services:** National income is always measured in money, but there are number of goods and services which are difficult to be assessed in terms of money. For example, painting as a hobby by an individual, the bringing up of children by the mother; these services are not included in national income as remuneration is not given to them. Also services of housewives and the services provided out of love, affection, mercy, sympathy and charity are not included in national income as they are not paid for. By excluding all such services, the national income is underestimated.

(4) **Income from illegal activities:** Income earned through illegal activities such as gambling, black marketing, theft, smuggling, etc. is not included in national income. But these goods and services do have value and meet the needs of the consumers. Thus, excluding income from illegal activities leads to underestimation of national income.

(5) **Treatment of government sector:** Government provides a number of public services like defense, public administration, law and order, etc. Measuring the exact market value of such government services is quite difficult, as the real value of these services is not known. Therefore, these services are considered as final consumption and their approximate values are added in the national income.

(6) **Production for self-consumption:** Goods produced for self-consumption such as food grains, vegetables and other farm produce do not enter the market. Therefore, it becomes difficult to find out their exact market value. Therefore, the value of such goods is estimated at the rate of market price that have been marketed. Thus, the approximate values of the goods produced for self-consumption are added in the national income.

(7) **Changing price level:** The difficulty of price changes arise in the national income estimate. When the price level in the country rises, the national income also shows an increase even though the production might have fallen and when price level falls, national income may show a decrease even though production may have increased. Thus, it becomes difficult to estimate the exact national income due to changing price level.

4. These factors are called exogenous or external factors as they are external factors as they are external to the individual's behavior, which, in turn, has a strong bearing on their consumption expenditures.

These are :

(1) Changes in Wage Rate : If income in terms of wage rate increases, consumption expenditure increases. A change in income distribution will cause change in expenditure on consumption.

(2) Change in Disposable Income : Consumption expenditure depends upon disposable income. If there is a change in disposable income there will be a change in expenditure on consumption.

(3) Change in the Rate of Interest : Change in the rate of interest is likely to affect consumption function. An increase in the rate of interest may have a dampening impact on consumption. On the other hand, a fall in the rate of interest may encourage people to consume more.

(4) Change in Capital Value (Windfall Gains or Unexpected Gains) : Capital gains are due to sudden change in money value of wealth. The consumption expenditure of wealthy classes is likely to be extremely susceptible to unforeseen change in the value of their wealth. During the period of prosperity, huge unexpected gains or windfall gains may accrue to the capitalist class, and as a result their consumption may increase. Some examples of windfall gains are unexpected rise in profits caused due to unexpected upswing in business. Unexpected rise in the rate of return on investment in some company's shares or debentures is also an example of windfall gain. All these windfall gains may cause increase in consumptions.

(5) Fiscal Policy : Changes in fiscal policy of the government affects consumption. Certain type of changes in fiscal policy adversely affect consumption. For example, increase in income tax, capital gains tax, excise duty etc. On the other hand, increase in government spending in various ways (including deficit financing) would increase propensity to consume.

(6) Expectations about the Future Income : If future income is expected to increase people are likely to save less and consume more. On the contrary, if future income is expected to fall, people may save more for the future and spend less on present consumption.

(7) Change in Depreciation Allowances : Increase in depreciation allowance would reduce income of shareholders and consequently, their consumption may decrease.

(8) Demographic Factor : Size of population, family size would affect consumption. Keynes, who was concerned with the problem of unemployment, was of the opinion that the above subjective and objective factors will not have very great influence on saving function in the short period. Keynes, therefore, believed that in the short period of time, consumption function and the saving function would be fairly stable.