



**J.K. SHAH**<sup>®</sup>  
TEST SERIES

Evaluate Learn Succeed

**SUGGESTED ANSWERS**

CA INTER

**Test Code – JK-FME-11**

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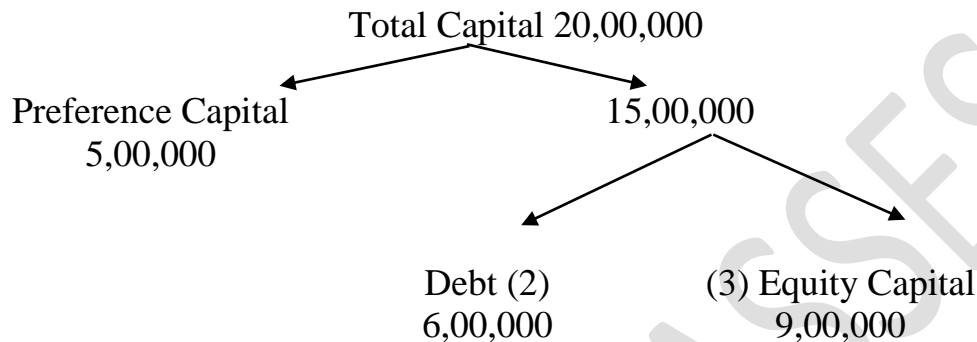
## Answers

### SECTION A - FINANCIAL MANAGEMENT

**Q.1**

**(a)**

**WN-1:**



**(1 Mark)**

**WN- 2: Post tax  $K_D$**

$$K_D = I(1-t)$$

$$= 16\% (1-0.30) = \boxed{11.20\%}$$

**(1 Mark)**

**Weighted Average Cost of Capital**

12% Preference Capital	5,00,000	25	12%	3	<b>(1 Mark)</b>
Equity Capital	9,00,000	45	20%	9	<b>(1 Mark)</b>
16% Debt	6,00,000	30	11.20%	3.36	
	20,00,000	100		15.36%	<b>(1 Mark)</b>

Weighted Average Cost of Capital = 15.36%.

**(b)**

#### Balance Sheet

Liabilities	Amount	Assets	Amount
Share Capital	4,00,000	Fixed Asset (?)	7,00,000
Reserves and Surplus	2,00,000	<b>Current Asset</b>	
Long Term Loan	3,00,000	Inventory	2,00,000
		Debtors	1,10,000
Creditors	2,00,000	Cash & Bank	90,000
	<b>11,00,000</b>		<b>11,00,000</b>

**(1 ½ Marks)**

**Working Notes:**

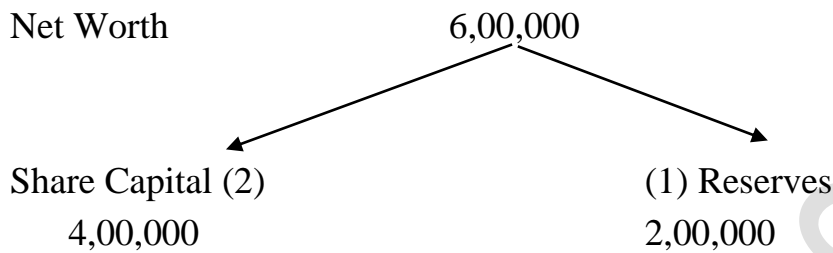
(1)  $\frac{\text{Long Term Loan}}{\text{Net Worth}} = \frac{1}{2}$

$\frac{3,00,000}{\text{Net Worth}} = \frac{1}{2}$

Net Worth = - 6,00,000

**(0.5 Mark)**

(2) Net Worth



**(0.5 Mark)**

(3) Total Asset Turnover Ratio

$= \frac{\text{Sales}}{\text{Total Assets}} = 2$

Sales = 22,00,000

**(0.5 Mark)**

(4) Gross Profit	10%	2,00,000
COGS	<u>100%</u>	<u>20,00,000</u>
Sales	<u>110%</u>	<u>22,00,000</u>

**(0.5 Mark)**

(5) Inventory Turnover Ratio

$= \frac{\text{COGS}}{\text{Average Stock}} = 10$

$= \frac{20,00,000}{\text{Average Stock}} = 10$

Average Stock = 2,00,000

**(0.5 Mark)**

(6) Average Collection Period

$$= \frac{\text{Debtors}}{\text{Credit Sales}} \times 360 = 36$$

$$\frac{\text{Debtors}}{[22,00,000 \times \frac{1}{2}]11,00,000} \times 360 = 36$$

$$\boxed{\text{Debtors} = 1,10,000}$$

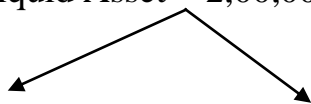
(0.5 Mark)

(7) Acid Test Ratio

$$= \frac{\text{Liquid Asset}}{\text{Current Liability}} = \frac{1}{1}$$

$$= \frac{\text{Liquid Asset}}{2,00,000} = \frac{1}{1}$$

Liquid Asset = 2,00,000



Debtors	Cash & Bank (?)
1,10,000	90,000

(0.5 Mark)

(c)

Expected EPS = 200 x 12% =  $\boxed{24}$

(0.5 Mark)

Expected Dividend = 24 x (1-0.75) =  $\boxed{6}$

(0.5 Mark)

Growth Rate = Retention Ratio x RoE  
 = 75% x 12% = 9%

(2 Marks)

$K_e = 15\%$

Now,  $P_0 = \frac{D_1}{K_e - g}$   
 $= \frac{6}{15\% - 9\%} = \boxed{100}$

Price of share is ₹100.

(2 Marks)

(d)

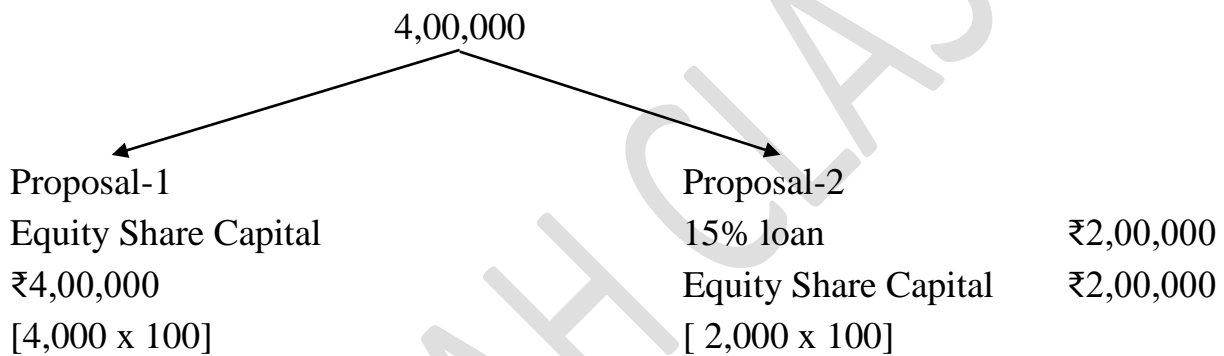
	Proposal-1	Proposal-2
EBIT	80,000	80,000
(-) Interest	-	(30,000)
EBT	80,000	50,000
(-) Tax @ 50%	(40,000)	(25,000)
PAT	40,000	25,000
÷ No. of equity shares	4,000	2,000
EPS	10	12.5

(3 Marks)

**Advice:** It is advisable to consider Proposal-2 of raising funds by Debt and Equity as it will give higher EPS.

(1 Mark)

**Working Note:**



(1 Mark)

## Q.2

## Working Note

## Income Statement

Particulars	Amount Lakhs
Sales	100
(-) Variable Cost	(20)
Contribution	80
(-) Fixed Cost (excluding Interest)	(20)
EBIT	20
(-) Interest (25 x 20%)	(5)
EBT	15
(-) Tax (40%)	(6)
PAT	9
(-) Preference Dividend (10 x 10%)	(1)
Profits for Equity Shareholders	8
÷ Number of Equity Shares	4
EPS	2

(5 Marks)

$$(1) \text{ EPS} = \boxed{\text{₹2/share}}$$

(1 Mark)

$$(2) \text{ DOL} = \frac{\text{Contribution}}{\text{EBIT}}$$

$$= \frac{40}{20} = \boxed{2}$$

(1 Mark)

$$(3) \text{ DFL} = \frac{\text{EBIT}}{\text{EBT}} \left[ \frac{\text{PD}}{1-t} \right]$$

$$= \frac{20}{15 - \left[ \frac{1}{1-0.4} \right]}$$

$$= \frac{20}{15 - 1.667}$$

$$= \frac{20}{13.333} = \boxed{1.50}$$

(1 Mark)

(4)  $DCL = DOL \times DFL$   
 $= 2 \times 1.50 = \boxed{3}$

(1 Mark)

(5) Financial BEP

$$= I + \left[ \frac{PD}{1-t} \right]$$

$$= 5 + \left[ \frac{1}{1-0.4} \right]$$

$$= 5 + 1.667 = \boxed{6.667}$$

(1 Mark)

**Q.3**

Particulars	Amount	
<b>Current Assets</b>		
- Debtors [10,000 x 90] x 2	18,00,000	(1 Mark)
<b>Stock</b>		
(a) Raw Material [10,000 x 40] x 1.5	6,00,000	(1 Mark)
(b) Finished Goods [10,000 x 90] x 1	9,00,000	(1 Mark)
(c) WIP [10,000 x 65 (40 + 10 + 15)] x 1	6,50,000	(1 Mark)
Cash Balance [20% of current liability]	2,40,000	(2 Marks)
(A)	41,90,000	(0.5 Mark)
<b>Current Liability</b>		
Creditors [10,000 x 40] x 3	12,00,000	(1 Mark)
(B)	12,00,000	(0.5 Mark)
<b>Working Capital Requirement</b>	29,90,000	(1 Mark)

**Working Note:**

(1)

Particulars	Per Unit
Direct Material	40
Direct Wages	20
Overheads (excluding Depreciation)	30
<b>Total Cost</b>	<b>90</b>

(1 Mark)

(2) For WIP material is assumed to be 100% completion stage and conversion cost 50%.

**Q.4**

**(1) Cash Budget for the period April to July.**

	<b>April</b>	<b>May</b>	<b>June</b>	<b>July</b>	
Opening Balance	10,000	7,000	4,500	2,500	<b>(1 Mark)</b>
(+) Receipts					
Collection from Debtors	30,000	33,000	36,000	39,000	<b>(1 Mark)</b>
(A)	40,000	40,000	40,500	41,500	
(-) Payments					
Wages & Expenses	11,000	11,500	12,000	12,500	<b>(1 Mark)</b>
Payment to Suppliers	22,000	24,000	26,000	28,000	<b>(1 Mark)</b>
(B)	33,000	35,500	38,000	40,500	
Closing Balance (A-B)	7,000	4,500	2,500	1,000	<b>(1 Mark)</b>

**(2) Profit and Loss Forecast for April to July.**

<b>Particulars</b>	<b>Amount</b>	
Sales	1,74,000	<b>(1 Mark)</b>
(+) Closing Stock (July Purchase)	32,000	<b>(1 Mark)</b>
	2,06,000	
(-) Opening Stock (March Purchase)	24,000	<b>(1 Mark)</b>
Purchases	1,16,000	<b>(1 Mark)</b>
Wages and other Expenses	47,000	<b>(1 Mark)</b>
<b>Net Profits</b>	<b>19,000</b>	

**Q.5**

**Note:** Here nature of project is not specified, so it is taken to be indivisible project.

<b>Project</b>	<b>Cost</b>	<b>PVCI</b>	<b>NPO</b>	<b>Rank</b>
1	2,000	2,420	420	5
2	12,000	15,120	3,120	1
3	10,000	11,700	1,700	2
4	4,000	4,520	520	4
5	5,000	6,000	1,000	3
6	1,000	1,190	190	6

**(5 Marks)**



**Feasible Options:**

	<b>Projects</b>	<b>Cost</b>	<b>NPV</b>	
Option 1	2	12,000	3,120	
	4	4,000	520	
		<b>16,000</b>	<b>3,640</b>	<b>(1 Mark)</b>
Option 2	1	2,000	420	
	3	10,000	1,700	
	4	4,000	520	
		<b>16,000</b>	<b>2,640</b>	<b>(1 Mark)</b>
Option 3	1	2,000	420	
	2	12,000	3,120	
	6	1,000	190	
		<b>15,000</b>	<b>3,730</b>	<b>(1 Mark)</b>
Option 4	3	10,000	1,700	
	5	5,000	1,000	
	6	1,000	190	
		<b>16,000</b>	<b>2,890</b>	<b>(1 Mark)</b>

**Advice:**

It is advisable to consider Project 1, 2, and 6 as it will give higher NPV.

**Q.6****(a)**

- External Commercial Borrowings (ECB) refer to Commercial Loans, which maybe in the form of Bank Loans, Buyers Credit, Suppliers Credit, Securitised Instruments (e.g. Floating Rate Notes or Fixed Rate Bonds), availed from Non-Resident Lenders, with minimum average maturity of 3 years. **(2 Marks)**
- Borrowers can raise ECBs through internationally recognised sources like (a) international Banks, (b) International Capital Markets, (c) Multilateral Financial Institutions e.g. ADB, (d) Export Credit Agencies, (e) Suppliers of Equipment, (f) Foreign Collaborators, and (g) Foreign Equity Holders. **(1 Mark)**
- ECB's can be accessed through - (a) Automatic Route (for Companies registered under the Companies Act, and NGOs engaged in micro-finance activities), or (b) Approval Route (i.e. after obtaining RBI / Government Approval). **(1 Mark)**

OR

(a)

1. **Meaning:** Venture Capital Financing refers to financing of high risk ventures promoted by new, qualified entrepreneurs who require funds to give shape to their ideas. Here, a financier (called Venture Capitalist) invests in the Equity or Debt of an Entrepreneur (Promoter Venture Capital Undertaking) who has a potentially successful business idea, but does not have the desired track record or financial backing.

(1 Mark)

Generally, venture capital funding is associated with - (a) heavy initial investment businesses, e.g. energy conservation, quality upgradation, or (b) sunrise sectors like information technology.

2. **Methods of Venture Capital Financing:** (3 Marks)

- (a) **Equity Financing:** VCU's generally require funds for a longer period but may not be able to provide returns to the investors during initial stages. Hence, Equity Share Capital financing is advantageous. The Investor's contribution does not exceed 49% of the total Equity Capital of the VCU. Hence, the effective control and ownership remains with the entrepreneur.
- (b) **Conditional Loan:** A Conditional Loan is repayable in the form of a royalty after the venture is able to generate sales. No interest is paid on such loans. The rate of royalty (say 2% to 15%) may be based on factors like - (i) gestation period, (ii) cash flow patterns, (iii) extent of risk, etc. Sometimes, the VCU has a choice of paying a high rate of interest (say 20%) instead of royalty on sales once the activity becomes commercially sound.
- (c) **Income Note:** It is a hybrid type of finance, which combines the features of both conventional loan & conditional loan. The VCU has to pay both interest and royalty on sales but at substantially low rates.
- (d) **Participating Debentures:** Interest on such debentures is payable at three different rates based on the phase of operations - (i) Start-up and commissioning phase - NIL Interest, (ii) Initial Operations Stage - Low rate of interest, and (iii) After a particular level of operations - High rate of interest.

(b)

	<b>Profit Maximization</b>	<b>Wealth Maximization</b>	
1.	Does not consider the effect of future cash flows, dividend decisions, EPS, etc.	Recognises the effect of all future cash flows, dividends, EPS, etc.	
2.	A Firm with Profit Maximisation objective may refrain from payment of dividend to its Shareholders.'	A Firm with Wealth Maximisation objective may pay regular dividends to its Shareholders.	
3.	Ignores time pattern of returns.	Recognizes the time pattern of returns.	<b>(0.5 Mark)</b>
4.	Focus on Short-Term.	Focus on Medium / Long-Term.	<b>(0.5 Mark)</b>
5.	Does not consider the effect of uncertainty / risk.	Recognises the risk-return relationships.	<b>(0.5 Mark)</b>
6.	Comparatively easy to determine the relationship between financial decisions and profits.	Offers no clear or specific relationship between financial decisions and share market prices.	<b>(0.5 Mark)</b>
7.	Leads to too naive decisions, e.g. (a) avoiding investments which result in immediate cash losses, but substantial revenues in the long-run, (b) postponing replacement expenditure to ensure short-term profits, etc.	Leads to systematic decisions using the tools and techniques of Capital Budgeting, Risk- Return Trade-off, Leverage Effect, etc.	<b>(0.5 Mark)</b>
8.	Focus on Entity's short term gains and profits.	Focus on long-term wealth of Entity, Shareholders and Society as a whole.	<b>(0.5 Mark)</b>

**(1 point = 0.5 Mark)**

(c)

1. **Meaning:** Factoring is an arrangement under which a Borrower receives advances against its receivables, from a financial institution (called Factor). The Factor also provides certain Allied Services, e.g. Debtors follow-up, Maintenance of Debtors Ledger, etc. on behalf of the Borrower.

(1 Mark)

2. **Types of Factoring:**

(a) **Disclosed v/s Undisclosed Factoring:** In Disclosed Factoring, all parties Factor, Borrower / Seller and the Buyer, is aware of the other's presence in the arrangement. However, in Undisclosed Factoring, the factoring arrangement is not known to the Buyer of goods.

(b) **Recourse v/s Non-Recourse Factoring:** In Recourse Factoring, in case of default by the customer, the risk of Bad Debts is borne by the Borrower and not the Factor. In Non-Recourse Factoring, the risk of bad debts is borne by the Factor himself. The rate of Commission is higher in case of Non-Recourse Factoring, to compensate the Factor for the additional risk borne by him.

In India, Factoring is always "disclosed" and "with recourse".

(1 Mark)

3. **Benefits:**

(a) **Convertibility:** Accounts receivables are easily converted into cash.

(b) **Pattern of Inflows:** Supply invoices are factored immediately. Hence, Cash Inflows follow the sale pattern.

(c) **Reduction in Collection and Administration Costs:** There is no need for a separate credit department since credit management may also be undertaken by the Factor.

(d) **Flexibility:** The Seller Firm may continue to finance its receivables continuously, on a more or less automatic basis. If value of sales increase or decrease, it can vary the financing proportionately.

(e) Compensating balances are not required in case of factoring, unlike Unsecured Loans. However, the Factor may not give 100% advance, he may reduce a reserve / margin and advance only the balance.

(1 Mark)

**SECTION B - ECONOMICS FOR FINANCE****Q.1****(a)**

- (i) Voluntary Export Restraints (VERs) refer to a type of informal quota administered by an exporting country voluntarily restraining the quantity of goods that can be exported out of that country during a specified period of time.
- (ii) Such restrains originate primarily considerations and are imposed based on negotiation of the importer with the exporter.
- (iii) The inducement for the exporter to agree to a VER is mostly to appease the importing country
- (iv) VERs are a result of requests made by the importing country to provide a measure of protection for its domestic businesses that produces competing goods.
- (v) VERs are often created because the exporting countries would prefer to impose their own restriction than risk sustaining worse terms from tariffs and/or quotas.
- (vi) Producers in the importing country experience an increase in well-being, though, as there is decreased competition, increased in price, profits, etc.

**(1 Mark)****(1 Mark)****(b)**

**Following are the general limitations in measurement of national income. GDP measures ignore the following:**

- i. Income distributions and, therefore, GDP per capita is a completely inadequate measure of welfare. Countries may have significantly different income distributions and, consequently, different levels of overall well-being for the same level of per capita income.
- ii. Quality improvement in systems and processes due to technological as well as managerial innovations which reflect true growth in output from year to year.
- iii. Productions hidden from government authorities, either because those engaged in it are evading taxes or because it is illegal (drugs, gambling etc.).
- iv. Non-market production (with a few exception) and Non-economic contributors to well-being for example: health of a country's citizens, education levels, political participation, or other social and political factors that may significantly affect well-being levels.
- v. The dis-utility of loss of leisure time. We know that, other things remaining the same a country's GDP rises if the total hours of work increase.

**(1 ½ Marks)**

- vi. Economic 'bads' for example: crime, pollution, traffic congestion etc. which makes us worse off.
- vii. The volunteer work and services rendered without remuneration undertaken in the economy, even though such work can contribute to social well-being as much as paid work.
- viii. Many things that contribute to our economic welfare such as, leisure time, fairness, gender equality, security of community feeling etc.,

(1 ½ Marks)

(c)

1. Allocation function: A market economy is subject to serious malfunctioning in several basic respects. There is also the problem of nonexistence of market in a variety of situations. While private goods will be sufficiently provided by the market, public goods will not be produced in sufficient quantities by the market. Market failures which hold back the efficient allocation of resources.

In the absence of appropriate government intervention, market failures may occur and the resources are likely to be misallocated by too much production of certain goods or too little production of certain other goods. The allocation responsibility of the governments involves suitable corrective action when private markets fail to provide the right and combination of goods and services. Briefly put, market failures provide the rationale for government's allocation function.

(1 ½ Marks)

2. Redistribution Function: The outcomes of this growth have not spread evenly across the households. The distribution responsibility of the government arises from the fact that, left to the market, the distribution of income and wealth among individual in the society is likely to be skewed and therefore the government has to intervene to ensure a more desirable and just distribution.

The redistribution function of the government aims at:

- redistribution of income to achieve an equitable distribution of societal output among household
- advancing the well-being of those members of the society who suffer from deprivations of different types
- providing equality in income, wealth and opportunities
- providing security for people who have hardships, and
- ensuring that everyone enjoys a minimal standard of living

(1 ½ Marks)

(d)

- i. Crowding out effect is the negative effect fiscal policy may generate when money from the private sector is crowded out' to the public sector.
- ii. In other words, when spending by government in an economy replaces private spending the latter is said to be crowded out.
- iii. For example, if government provided free computers to students, the demand from students for computers may not be forthcoming.
- iv. When government increases it's spending by borrowing from the loanable funds from market, the demand for loans increases and this pushes the interest rates up.
- v. Private investments are sensitive to interest rates and therefore some private investment spending is discouraged.
- vi. Similarly, when government increases the budget deficit by selling bonds or treasury bills, the amount of money with the private sector decreases and consequently interest rates will be pushed.
- vii. Because of government to much borrowing private investments are thrown out this is known as crowding out.

(2 Marks)

Q.2

(a)

- (i) Common access resources or common pool resources are a special class of impure public good which are non-excludable as people cannot be excluded from using them. These are rival in nature and their consumption lessens the benefits available for others. This rival nature of common resources is what distinguishes them from pure public goods, which exhibit both non-excludability and non-rivalry in consumption.

Since price mechanism does not apply to common resources, producers and consumer do not pay for these resources and therefore, they overuse them and cause their depletion and degradation. This creates threat to the sustainability of these resources and, therefore, the availability of common access resources for future generations.

(2 Marks)

Economist use them '**tragedy of the commons**' to describe the problem which occurs when rivalrous but non-excludable goods are overuse, to the disadvantage of the entire world. Example of common access resources are fishers, common pastures, rivers, sea, backwaters biodiversity etc.

(1 Marks)

**(ii) Marginal Standing Facility (MSF):**

1. MSF started in the year 2011. (RBI lender of last resort)
2. MSF refers to the facility under which schedule commercial bank can borrow additional amount up to 1% of NDTL for overnight purpose.
3. MSF will be activated when commercial banks have exhausted all borrowings option currently it is 4.65%.
4. Minimum amount to be borrowed 1 cr. or in multiplies of that.
5. Banks can borrow MSF on all working days except Saturday between 7 PM to 7.30 PM in Mumbai.

**(1 ½ Marks)**

<b>Instrument</b>	<b>Interest rates</b>
Reserve repo rate	Lower band
Repo rate	Middle band
MSF	Upper band

**(0.5 Mark)**

**(b)**

**Common access resources or common pool resources are a special class of**

<b>Particulars</b>	<b>Industry A</b>	<b>Industry B</b>	<b>Industry C</b>
Sale Price of Output	400 + 200 + 1,000 = 1,600	500 + 800 = 1,300	<b>600 + 500 = 1,100</b>
Less: Cost of Intermediate Consumption	100	400	<b>200 + 500 = 700</b>
Value Added by Industry	<b>1,500</b>	<b>900</b>	<b>400</b>

**(3 Marks)**

GDP at Market Price = <b>GNP at Market Prices</b> (no Net Factor Income from abroad)	2,800 (100)
<b>Less:</b> Indirect Taxes	
<b>Add:</b> Subsidies	50
<b>Gross National Product at Factor Cost</b>	<b>2,750</b>
<b>Less:</b> Depreciation	(100)
<b>Net National Product at Factor Cost</b>	<b>2,650</b>
<b>Less:</b> Subsidies	(50)
<b>Add:</b> Indirect Taxes	100
<b>Net National Product at Market Prices</b>	<b>2,700</b>

**(2 Marks)**



**Q.3****(a)**

- (i) International trade is the exchange of goods and services as well as resources between countries. It involves transactions between residents of different countries. Whereas domestic trade or internal trade involves exchange of goods and services within the domestic territory of a country.

**Advantages of international trade? (MERITS)**

International trade may lead to a lot of advantages for countries as it leads to opening up of the global economy leading to expansion of the domestic market internationally. Following are the arguments in the favour of international Trade:

- It is a powerful stimulus to economic efficiency and contributes to economic growth and rising incomes.
- It enables companies to reap the quantitative and qualitative benefits of extended division of labour.
- Manufacturing capabilities and benefits from economies of large scale production.
- Reduction in domestic price due to increased competition thereby increasing the living standard of citizens.
- International trade provides access to new markets and new materials and enables sourcing of inputs and components internationally at competitive prices.
- Exports stimulate economic growth by creating jobs, which could potentially reduce poverty.

(1 ½ Marks)

**Disadvantages of International Trade (DEMERITS)**

- Possible negative labour market outcomes in terms of labour-saving technological change that depress demand for unskilled workers, loss of labourers bargaining power.
- Economic exploitation is a likely outcome when underprivileged countries become vulnerable to the growing political power of corporations operating globally.
- Excessive stress on exports and profit-driven exhaustion of natural resources due to unsustainable production and consumption.
- It may have an adverse effect on the development of domestic industries and may even threaten the survival of infant industries.

- Risky dependence of underdeveloped countries on foreign nation impairs economic autonomy and endangers their political sovereignty.
- Instead of cooperation among nation, trade may breed rivalry on account of severe competition.

(1 ½ Marks)

(ii)

$$(a) \text{ Credit Multiplier} = \frac{1}{\text{Required Reseve Ratio}}$$

$$\text{For RRR} = 0.015, \text{ Credit Multiplier} = \frac{1}{0.015} = 66.667$$

(1 Mark)

$$(b) \text{ Credit Creation} = \text{Initial Deposit} \times \frac{1}{\text{RRR}}$$

$$\text{For RRR} = 0.06, \text{ Credit creation will be } 5200 \times \frac{1}{0.06} = 86.666.67$$

(1 Mark)

(b)

(i) **Quasi Public Goods focuses on the mix**

services that arise from the provision of the good. For example, if one gets sterilized against measles, it confers not only a private benefit to the individual, but also an external benefit because it reduces the chances getting infected of other person who are in contact with him. You can observe here that the external effect associated with the consumption of a private good may have the characteristic of a public good.

(1 ½ Marks)

The quasi-public goods or services, also called a near public (for e.g. education, health services) possess nearly all the qualities of the private goods and some of the benefits of public good. It is easy 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.

(1 ½ Marks)

(ii)

- LAF started in year 2000. (RBI is Bankers Bank)
- LAF is a window available with central bank known as discount window which provides financial accommodation to commercial banks

- c. It helps at the time of Liquidity shortage and control short term Interest rate, through Repo and Reverse repo auction (1 Mark)
1. **Repo Auction:** It is a rate at which commercial bank borrows money from central bank by keeping some security mortgage which could be repurchased at later stage. Currently repo rate is 4% **Repo operation helps to inject liquidity into the market**
  2. **Reverse Repo:** It is a percentage that central bank borrows from commercial bank by keeping securities as mortgage. Currently it is 3.35% Reverse repo operation absorbs liquidity in the system.  
**LAF is conducted at a fixed time on daily basis on all working days in Mumbai (excluding Saturdays). (1 Mark)**

#### Q.4

(a)

(i) **These limitations are as follows:**

1. One of the biggest problems with using discretionary fiscal policy to counteract fluctuations is the different types of lags involved in fiscal-policy action. There are significant lags are:
  - Recognition lag: The economy is a complex phenomenon and the state of the macroeconomic variable is usually not easily comprehensible. Just as in case of any other policy, the government must first recognize the need for a policy change.
  - Decision lag: Once the need for intervention is recognized, the government has to evaluate the possible alternative policies. Delays are likely to occur to decide on the most appropriate policy.
  - Implementation lag: even when appropriate policy measures are decided on, there are possible delays in bringing in legislation and implementing them.
  - Impact lag: impact lag occurs when the outcomes of a policy are not visible for some time.(1 ½ Marks)
2. Fiscal policy changes may at time be badly timed due to the various lags so that it is highly possible that an expansionary policy is initiated when the economy is already on a path of recovery and vice versa.
3. There are difficulties in instantaneously changing government's spending and taxation policies.

4. It is practically difficult to reduce government spending on various items such as defence and social security as well as on huge capital project which are already midway.
5. Public works cannot be adjusted easily along with movements of the trade cycle because many huge projects such as highway and dams have long gestation period. Besides, some urgent public project cannot be postponed for reasons of expenditure cut to correct fluctuation caused by business cycles.
6. Due to uncertainties, there are difficulties of forecasting when period of inflation or deflation may set in and also promptly determining the accurate policy to be undertaken.
7. There are possible conflicts between different objectives of fiscal policy such that a policy designed to achieve one goal may adversely affect another. For example, an expansionary fiscal policy may worsen inflation in an economy.

(1 ½ Marks)

- (ii) Pump priming involves a one-shot injection of government expenditure into a depressed economy with the aim of boosting business confidence and encouraging larger private investment. It is a temporary fiscal stimulus in order to set off the multiplier process. The argument is that with a temporary injection of purchasing power into the economy through a rise in government spending financed by borrowing rather than taxes, it is possible for government to bring about permanent recovery from a slump. Pump priming was widely used by governments in the post-war era in order to maintain full employment; however, it became discredited later when it failed to halt rising unemployment and was held responsible for inflation.

(2 Marks)

(b)

- (i) Monetary policy encompasses all actions of the central bank which are aimed at directly controlling the money supply and indirectly at regulating the demand for money.

Following are some of the important **objective of the Monetary Policy**:

The most commonly pursued objectives of monetary policy of the central banks across the world are maintenance of price stability (or controlling inflation) and achievement of high level of economy's growth and maintenance of full employment.

(0.5 Mark)

- To regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.
- To promote rapid economic growth, and price stability (inflation /deflation)
- To maintain a robust debt management.
- To sustain a moderate structure of interest rates to encourage investments,
- To maintain exchange rate stability and external balance of payment equilibrium
- To ensure an adequate flow of credit to the productive sectors
- To create an efficient market for government securities.

(2 ½ Marks)

(ii)

1. While national income is income earned by factors of production, Personal Income is the income received by the household sector including Non-Profit Institutions Serving Households. Thus, national income is a measure of income earned and personal income is a measure of actual current income receipt of persons from all sources which may not be earned from productive activities during a given period of time.
3. In other words, it is the income 'actually paid out' to the household sector, but not necessarily earned. Examples of this include transfer payment such as social security benefits, unemployment compensation, welfare payment etc.
4. Individuals also contribute income which they do not actually receive; for example, undistributed corporate profits and the contribution of employers to social security. Personal income forms the basis for consumption expenditures and is derived from national income as follows: (1 ½ Marks)

PI = NI + income received but not earned – income earned but received.

- Income received but not earned = Transfer in incomes
- Income earned but not received = Social security benefits, undistributed corporate profits (0.5 Mark)

## Q.5

(a)

- (i) Milton Friedman (1956) extended Keynes' speculative money demand within the framework of assets price theory. Friedman treat the demand for money as nothing more than the application of a more general theory of demand for capital assets.

Demand for money is affected by the same factors as demand for any other assets, namely

1. Permanent income.
2. Relative return on assets. (Which incorporate risk).

Friedman maintains that it is permanent income and not current income that determines the demand for money. Permanent income – which is Friedman's measure of wealth is the present expected value of all future income.

(1 ½ Marks)

**Friedman identifies the following four determinates of the demand for money. The nominal demand for money:**

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

(1 ½ Marks)

- (ii) **Ad valorem tariff:** An ad valorem tariff is levied as a constant percentage of the monetary value of one unit of the imported good.it is levied on the total value of the commodity

Duty or other charges levied on an item on the basis of its value and not on the basis of its quantity, size, weight, or other factor.

(2 Marks)

**(b)**

(i) Depreciation lowers the relative price of a exports and raises the relative price of its imports. When a country's currency depreciates, foreigners find that its exports are cheaper and domestic residents find that imports from abroad are more expensive. **(0.5 Mark)**

- Importers will be affected most as they will have to pay more rupees on importing products.
- A depreciation of domestic currency primarily increases the price of foreign goods relative to goods produced in the home country and diverts spending from foreign goods to domestic goods. Increased demand, both for domestic import-competing goods and for exports encourages economic activity and creates output expansion.
- By lowering exports prices, currency depreciation helps increase the international competitiveness of domestic industries, increases the volume of exports and promotes trade balance.
- When a country's currency depreciates, production for exports and of import substitutes become more profitable.
- The fiscal health of a country whose currency depreciates is likely to be affected with rising export earnings and import payments and consequent impact on current account balance.
- Depreciation is also likely to add to consumer price inflation in the short run, directly through its effect on prices of imported consumer goods and also due to increased demand for domestic goods.

**(2 ½ Marks)**

(ii) **Features of private goods:**

- Owner of private goods can exercise private property right and can prevent others from using the good or consuming their benefits.
- Private goods are 'excludable' i.e. it is possible to exclude or prevent consumers who have not paid for them from consuming them or having access to them
- Private goods do not have free rider problem. This means that the private goods will be available to only those persons who are willing to pay for it.
- Normally, the market will efficiently allocate resources for the production of private goods.

- The producer and seller will be able to generate more revenue thereby increasing their profit if they are able to increase the market demand for their products.
- Market equilibrium can be achieved in the production of private goods wherein the supply will always try to match the quantity demanded.

(2 Marks)

**OR**

**(b)**

**(i)**

Foreign Portfolio Investment (FDI) also very commonly known as **Foreign Institutional Investment**, consists of securities and other financial assets passively held by foreign investors. It does not provide the investor with direct ownership of financial assets and is relatively liquid depending on the volatility of the market.

Unlike FDI, portfolio capital, in general, moves to investment in financial stocks, bonds and other financial instruments and is effected largely by individuals and institutions through the mechanism of capital market. These flows of financial capital have their immediate effect on balance or exchange rates rather than on production or income generation.

(1 ½ Marks)

Foreign portfolio investment (FDI) is not concerned with either manufacture of goods or with provision of services. Such investor also do not have any intention of exercising voting power or controlling or managing the affairs of the company in whose securities they invest. The singular intention of a foreign portfolio investor is to earn a remunerative return through investment in foreign securities

(0.5 Mark)