

**EXAMINATION CAPSULES**

**CBSE 2017**

**ECONOMICS**  
**XII**

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## MOST EXPECTED QUESTIONS: 2017

### 1. What is economics all about? Distinguish between its two branches Micro and Macro Economics.

**Ans:** - Economics is all about making choices in the presence of scarcity.

#### Difference between Micro and Macro Economics

Sl. No.	Micro Economics	Macro Economics
i	Microeconomics is the branch of economics which study individual economic variable / unit.	Macroeconomics is the branch of economics which study economy as whole and its aggregates.
ii	The main tools of micro economics are demand and supply.	The main tools of macro economics are aggregate demand and aggregate supply.
iii	The main problem studied is price determination.	The main problem studied is income and employment determination.
iv	Microeconomics is a partial equilibrium analysis.	Macro economics is a general equilibrium analysis.
v	The major microeconomic variables are price, individual consumer's demand, wages, rent, profit, revenue, etc.	The major macroeconomic variables are aggregate price, aggregate demand, aggregate supply, inflation, unemployment, etc.

### 2. What do you mean by economic problem? Why does an economic problem arise? Explain.

**Ans:** - **Economic problem** – The problem of choice that arises due to multiplicity of wants and scarcity of resources is called economic problem.

The main reasons for arising economic problems are as follows -

**i. Unlimited wants** - Human wants are many in numbers and recurring in nature. A man can not satisfy all of his wants and therefore it has to make a choice in order of priority/urgency.

**ii. Limited resources** - The resources are limited in relation to need for them. Therefore it has to make a choice that how to use the resources.

**iii. Alternative use of resources** - A resource can be utilised in a different way and for different purposes. Therefore choice has to be made among different uses of resources.

### 3. Explain the problem of 'what to produce' with the help of an example.

**Ans:** - **What to Produce** - It is the problem of selection of goods. It has two aspects- what commodity is to be produced and in what quantity.

This problem arises because economy has to produce so many types of goods like consumer goods - capital goods, war goods - civil goods, necessity goods -

luxury goods etc. An economy has limited resources and the wants are unlimited, so all goods and services cannot be produced. Therefore, economy has to decide which goods are to be produced. The decision is generally depend on the demand of the society.

For example, on a given piece of land, all crops cannot be grown. If it is used for growing wheat, then on the area on which wheat is grown other crops cannot be grown. This is the problem of what to produce.

#### 4. Explain the problem of 'how to produce' with the help of an example.

**Ans: - How to Produce** - This problem relates to selection of the technique of production of goods. Generally, most of the goods can be produced by using more than one technique. Mainly there are two techniques: labour intensive technique (a technique in which more labour and less capital is used) and capital intensive (a technique in which more capital and less labour is used). Since the resources are scarce, so a decision is to be taken that which technique to be used. For example, cloth can be produced with labour intensive technique as well as capital intensive technique. Which technique to choose is the problem of 'how to produce'.

#### 5. Distinguish between Positive and normative economics

**Ans: - Difference between Positive and normative Economics**

Sl. No.	Positive Economics	Normative Economics
1	Positive Economics deals with things as they are.	Normative Economics is suggestive in nature.
2	This is generally relate to 'what is', 'what was' and 'what will be' under given circumstances.	This is generally relate to 'what ought to be' under given circumstances.
3	This deals with realistic situation.	This deals with idealistic situation.
4	These statements can be empirically verified as they are based on fact.	These statements cannot be empirically verified as they are not based on fact.
5	E.g- There is poverty in India.	E.g.- Poverty in India should be reduced.

#### 6. Define opportunity cost, marginal opportunity cost and economy.

**Ans: - Opportunity cost** - The amount of next best alternative which has been given up (scarified) in order to produce a good is called *opportunity cost*.

**Marginal opportunity cost** - The amount of other good which has been given up (scarified) in order to produce an additional unit of a good is called *marginal opportunity cost*.

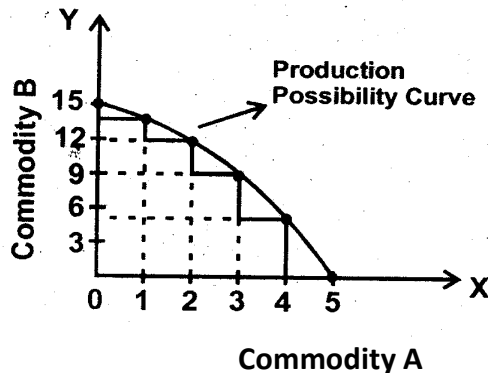
**Economy** is a system in which and by which people get their living. In other words it's a framework within which all the economic activities of a country take place.

### 7. Define production possibility curve (PPC) and explain its main characteristics.

**Ans: - Production Possibility Curve** is a curve which shows all the possible combinations of two goods which an economy can produce with full and efficient utilisation of its given resources and technology in a given period of time.

#### Production Possibilities

Production Possibility	Commodity A	Commodity B	Marginal opportunity cost of commodity A
A	0	15	-
B	1	14	$15-14=1$
C	2	12	$14-12=2$
D	3	9	$12-9=3$
E	4	5	$9-5=4$
F	5	0	$5-0=5$



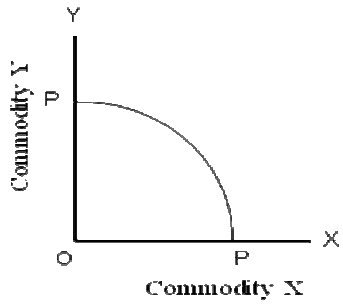
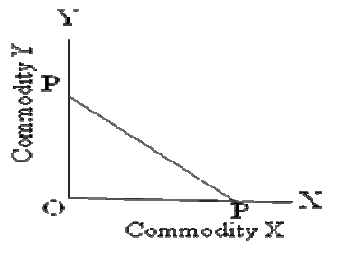
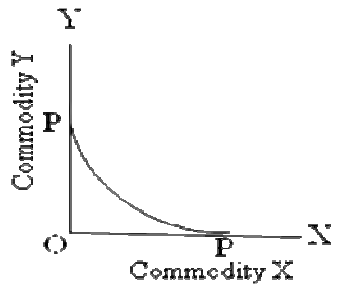
#### Characteristics of PPC-

- i) **PPC is downward sloping-** PPC assume that all the resources in the economy are fully and efficiently utilized so in order to increase the production of one good economy has to decrease the production of other good. Thus it is downward sloping.
- ii) **PPC is concave to origin** –PPC is concave to origin because of increasing Marginal rate of transformation (MRT) / Marginal opportunity cost (MOC). Marginal rate of transformation (MRT) increases because it assumes that all the resources are not equally efficient to produce all the goods. Therefore, as resources are transferred from one good to another good, less and less efficient resources are transferred it increases the cost and MRT.

**8. What shape will PPC take when marginal rate of transformation decreases, constant and increases?**

**Ans: -**

**Marginal rate of transformation and shape of production possibility curve**

MRT	Nature of PPC	Shape of PPC
Increasing	Concave to origin	
Constant	Downward sloping straight line	
Decreasing	Convex to origin	

**9. Define the law of Diminishing Marginal Utility and 'Principle of Equi-Marginal Utility'.**

**Ans: - Law of diminishing Marginal Utility** - This law states that other things remain constant as a consumer consumes more and more units of a commodity, the marginal utility derive from the successive units of that commodity tends to decrease.

**Principle of Equi-Marginal Utility** – It states that consumer will allocate his expenditure on different goods in such a way that the utility gained from the last rupee spent on each commodity is equal.

**10. Define consumer equilibrium. Explain one (single) commodity model of consumer equilibrium through utility analysis.**

**Ans :- Consumer's equilibrium** - It refers to a situation in which a consumer gets maximum satisfaction and he has no tendency to change in his existing expenditure (consumption) pattern .

### Consumer equilibrium — Single commodity case

If consumer consumes only one good then consumer's equilibrium is attained when marginal utility of commodity in terms of money becomes equal to its price i.e.  $MU_X = P_X$ .

Since it is difficult to compare MU of a good (expressed in utiles) with its price (expressed in ₹). Therefore MU of a good is first converted in terms of money by dividing MU of a good by MU of a rupee.

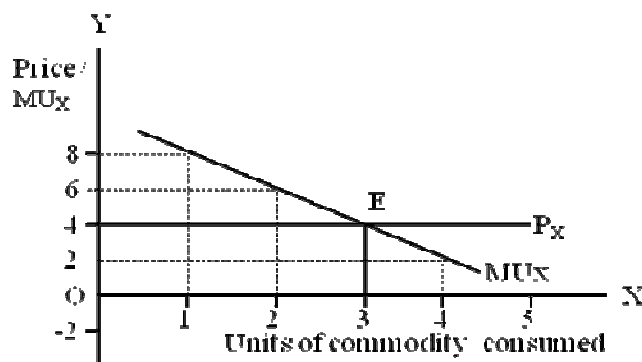
$$MU_X = MU_X (\text{in terms of money}) = \frac{MU_X (\text{in utiles})}{MU_M}$$

Where  $MU_M$  = Marginal utility of money

**Marginal utility of money** refers to the extra satisfaction which a consumer derives by spending an additional unit of rupee on other available goods.

We can explain one commodity model with the help of example as follows: Suppose a consumer is purchasing commodity X and the price of each unit of X is ₹ 4. Hypothetical marginal utility schedule of commodity X is given as:

Units of commodity X Consumed	Marginal Utility (in terms of ₹)	Price (₹)	Remark
1	8	4	MU > P
2	6	4	
3	4	4	MU = P
4	2	4	MU < P



In above table and diagram, when consumer will purchase 3 units of commodity X he will reach an equilibrium position because the condition of consumer's equilibrium  $MU_X (\text{in ₹}) = P_X$  is satisfied. At this level of consumption, the marginal utility of X is equal to the price of commodity X i.e. ₹ 4.

If he purchase less than 3 units say 2 units then the marginal utility derive from 2 units is ₹ 6 and the price which he pays is ₹ 4. Since his  $MU_X > P_X$ . Therefore he will purchase more quantity of commodity X and vice versa.

Hence consumer will be in equilibrium only at that point where  $MU_X = P_X$ .

### 11. What are 'monotonic preferences'? Explain with the help of an example.

**Ans:- Monotonic preferences-** A consumer preferences are said to be monotonic if and only if, between any two bundles of the two goods, he prefers that bundle which has at least more quantity of one good but no less of other good.

**Example -** If bundle A (3,5) and bundle B (3,2) are available to the consumer, then consumer will prefer **bundle A** over **bundle B** as bundle A consists of more units of good 2 than bundle B.

### 12. What do you mean by marginal rate of substitution (MRS)?

**Ans: - Marginal Rate of Substitution (MRS) -** The amount of other commodity which has been sacrificed (given up) in order to consume an additional unit of a commodity is called marginal rate of substitution.

### 13. What do you mean by Indifference curve? State its main Features.

**Ans: - Indifference curve** is a curve which shows various combinations of two goods which give same level of satisfaction to the consumer.

#### Properties or Feature of Indifference curve-

1. **IC is downward sloping** - It is always downward sloping because IC assumes that the combination of both the goods gives a certain level of satisfaction to the consumer. So, in order to increase the consumption of one commodity consumer has to decrease the consumption of another commodity.

2. **IC is convex to origin** - It is convex to origin because of decreasing Marginal rate of substitution (MRS). This is because, as the consumer has more and more units of X, its marginal significance to him declines. So he is willing to give up less and less units of Y for an increment in X.

3. **Higher IC shows higher level of satisfaction** - As compared to lower IC, certainly higher IC show higher level of satisfaction. It is because higher IC has more quantity of one good without reducing quantity of another good.

4. **ICs do not intersect each other** - Each IC represents different level of satisfaction, so there intersection is ruled out.

### 14. Define Budget line. Give the formula for calculating the slope of the budget line. Briefly explain the factors that cause changes in the Budget line.

**Ans: - Budget line** - It's a line which shows various combinations of two goods which a consumer can purchase with his given income and given prices of the goods.

**Slope of the budget line-** It is equal to the ratio of the prices of the two commodities.

$$\text{Slope of the budget line} = (-) \frac{P_1}{P_2}.$$

Where  $P_1$  is price of good 1 and  $P_2$  is price of good 2.

**Changes in the Budget line** - The factors which cause change in budget line are-

**a) Change in consumer Income** - If consumer income increases, then he can purchase more quantities of both the goods. Therefore, budget line of consumer shifts rightward and vice versa.

**b) Change in prices of commodities** - If prices of both the commodities decreases then, consumer can purchase more quantities of both the goods. So, budget line shifts rightward and vice versa.

### 15. Explain the concept of consumer equilibrium with help of indifference curve approach.

**Ans: - Consumer's Equilibrium** - A consumer shall be in equilibrium where he can maximize his satisfaction subject to his budget constraint and does not want to bring any change in it.

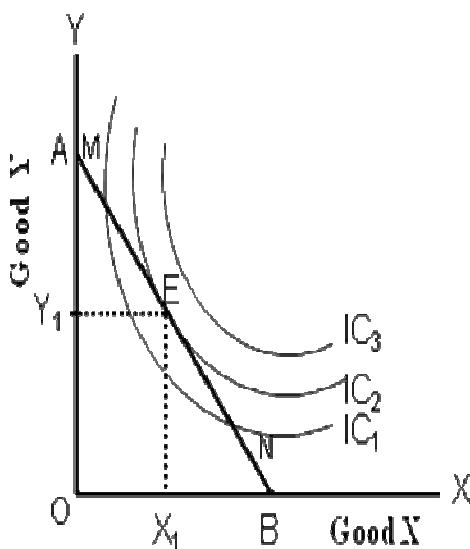
Indifference curve approach explains the consumer equilibrium with the help of indifference map and budget line.

**Conditions of Consumer's Equilibrium** - If consumer is consuming two goods say good X and good Y. Then at equilibrium point-

i) Budget line should be tangent to indifference curve i.e. slope of indifference curve and budget line is equal to each other. It means  $MRS_{XY} = \frac{P_X}{P_Y}$

ii) Indifference curve should be convex to the point of origin i.e.  $MRS_{XY}$  is decreasing.

We can explain it with the help of following diagram-



In diagram, AB is budget line and three indifference curves are  $IC_1$ ,  $IC_2$  and  $IC_3$ . The various combinations of good X & good Y which consumer can purchase with his given income are M, E and N. But M & N lie on  $IC_1$  whereas E lies on  $IC_2$ . Since E is on higher indifference curve, so it will give more satisfaction to the consumer as compared to M & N. At point E budget line is tangent to  $IC_2$ , and  $IC_2$  is convex to origin. So E is equilibrium point where consumer will get maximum satisfaction by consuming  $OX_1$  quantity of good X and  $OY_1$  quantity of good Y.



**16. What do you mean by demand? Explain the determinants of demand  
For a commodity.**

**Ans: - Demand** - The quantity of a commodity which a consumer wish to purchase at given price and given period of time is called demand.

**Determinants of demand-** The main determinants of demand for a commodity are as follows-

**i) Price of the commodity-** When the price of a commodity increases the demand for that commodity decreases and vice versa. It means there is inverse relationship between price of commodity and quantity demanded.

**ii) Income of the consumer** - The income of consumer affects the demand of commodity as follows-

The demand for normal goods tends to increase with increase in consumer income and vice-versa. On the other hand, the demand for inferior goods tends to decrease with increase in consumer income and vice-versa

**iii) Taste and preferences-** When taste and preferences are in favour of the commodity demand for commodity increases and vice versa.

**iv) Future expectation of change in price of good-** If it is expected that price of commodity will increase in future ,consumer starts purchasing the commodity more at present. Therefore demand of commodity increases at present and vice versa.

**v) Price of related goods** - The related goods are of two types- complementary goods (The goods which are used together) and supplementary good (The goods which are used in place of each other).

In case of complementary goods, demand of a good rises with fall in price of complementary good and vice versa.

In case of substitute goods, demand of a good falls with a fall in the price of other substitute goods and vice versa.

The above five factors affect the individual demand. But for market demand some more factors including above are as under -

**vi) Government policy** - When government increases the tax on a particular commodity, the commodity become costlier, so less number of consumers will purchase the commodity. Hence demand of commodity decline and vice versa.

**vii) Population-** With increase in population of a country demand for commodity rises. However, if the population is decreasing, then demand will fall.

**viii) Climate** - If climate of an area is favourable for the consumption of a good then demand for the good will be more and vice versa.

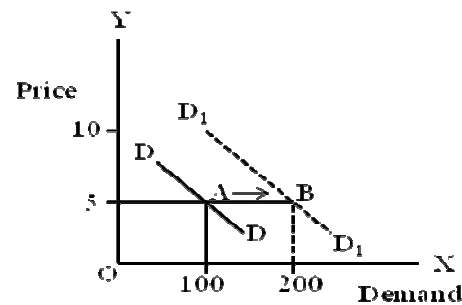
**17. What do you mean by increase in demand? Name any five factors that shift the demand curve to the right.**

**Ans:- Increase in demand** - Keeping price constant, if demand of a commodity increases due to some other factors affecting demand, such as increase in consumer income for normal goods, decrease in price of complementary good, change in taste and fashion in favour of a commodity etc. is called increase in demand.

In this case a consumer shifts rightward on a new demand curve so also called rightward shift of demand curve.

We can express it with the help of schedule and diagram as under-

Price (₹)	Demand (Units)
5	100
5	200



A → B shows increase in demand

The Factors those shift the demand curve to the right or responsible for increases in demand are -

- Increase in income of consumer in case of normal good.
- Rise in price of substitute goods.
- Fall in price of complementary goods.
- Favorable change in taste etc.
- Future expectation to increase the price of commodity.

**18. Explain the law of demand with the help of a demand schedule and demand curve.**

**Ans: - Law of demand-** This law states that other things remain constant a consumer purchases more quantity of a commodity at lesser price and less quantity at higher prices.

It means there is inverse relationship between price of commodity and quantity demanded.

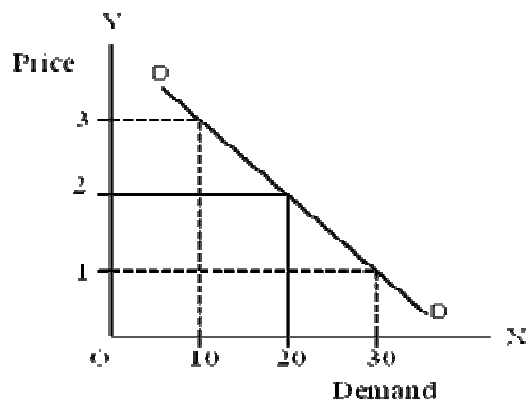
**Assumptions of law of demand** - (Other things remain constant)

- No change in consumer's income.
- No change in prices of other related goods.
- No change in taste and fashion.
- No change in future expectation regarding change in price of commodity

## Explanation of law-

We can explain it with the help of following schedule and diagram:

Price (₹)	Quantity demanded (Units)
3	10
2	20
1	30



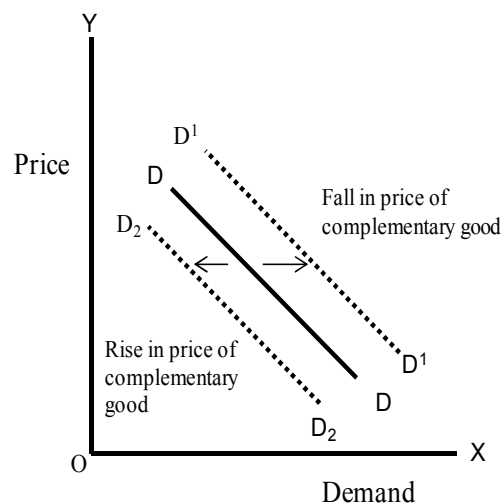
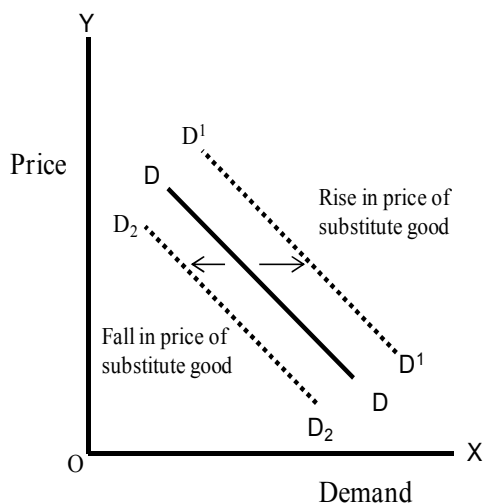
The above schedule and diagram show that as price falls quantity demanded rises. Hence prove the law of demand.

### 19. How is demand of a commodity affected by change in the price of related goods? Explain with the help of diagram.

**Ans:** - Related good can be of two type - substitute and complementary.

**Substitute goods** are those goods, which can be used in place of each other. E.g. coffee and tea. An increase in the price of a substitute good (Coffee) causes an increase in the demand for the commodity (Tea). This will cause rightward shift of demand curve and vice versa.

**Complementary goods** are those goods, which are used with each other. E.g. car and petrol etc. In case of complementary goods, the demand for a commodity raises with the fall in the price of other commodity. If the price of the car falls its demand will rise, then the demand for petrol will also rise. This will cause a rightward shift of demand curve of given commodity and vice versa.



**20. Distinguish between**

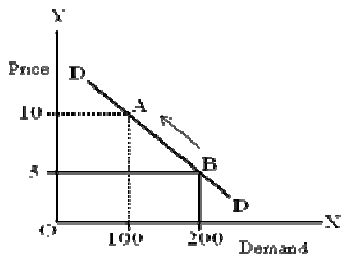
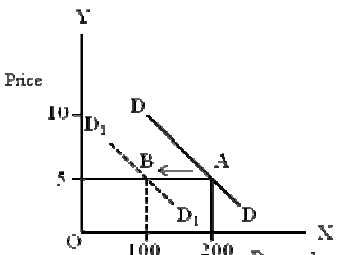
- a) Change in demand and change in quantity demanded**
- b) Contraction of demand and decrease in demand.**

**Ans:-**

**a) Difference between change in demand and change in quantity demanded**

Sl. No.	Change in demand	Change in quantity demanded																
i	Keeping price constant, if demand of the commodity changes due to change in some other factors, such as change in consumer income, change in prices of substitute goods etc. is called change in demand.	Other things remain constant, if demand of commodity changes due to change in its price, is called change in quantity demanded.																
ii	The main causes are- change in consumer income, change in prices of substitute goods, change in taste and preferences etc.	The main cause is change in price of commodity.																
iii	It results a shift of demand curve.	It results in movement along a demand curve.																
iv	Demand Schedule - <table border="1" style="margin-left: auto; margin-right: auto;"> <thead> <tr> <th style="text-align: center;">Price (₹)</th> <th style="text-align: center;">Demand (Units)</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">2</td> <td style="text-align: center;">10</td> </tr> <tr> <td style="text-align: center;"><b>2</b></td> <td style="text-align: center;"><b>20</b></td> </tr> <tr> <td style="text-align: center;">2</td> <td style="text-align: center;">30</td> </tr> </tbody> </table>	Price (₹)	Demand (Units)	2	10	<b>2</b>	<b>20</b>	2	30	Demand Schedule - <table border="1" style="margin-left: auto; margin-right: auto;"> <thead> <tr> <th style="text-align: center;">Price (₹)</th> <th style="text-align: center;">Demand (Units)</th> </tr> </thead> <tbody> <tr> <td style="text-align: center;">3</td> <td style="text-align: center;">10</td> </tr> <tr> <td style="text-align: center;"><b>2</b></td> <td style="text-align: center;"><b>20</b></td> </tr> <tr> <td style="text-align: center;">1</td> <td style="text-align: center;">30</td> </tr> </tbody> </table>	Price (₹)	Demand (Units)	3	10	<b>2</b>	<b>20</b>	1	30
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v	Demand curve -	Demand curve-																

**b) Contraction of demand and decrease in demand**

Sl. No.	Contraction of demand	Decrease in demand												
i	Other things remain constant, if demand of commodity decreases due to increase in price of the commodity is called contraction of demand.	Keeping price constant, if demand of a commodity decreases due to some other factors affecting demand is called decrease in demand.												
ii	The reason of contraction of demand is increase in price.	The main reasons of decrease in demand are - decrease in income of consumer in case of normal good, fall in price of substitute good, rise in price of complementary good, unfavorable change in taste etc.												
iii	In this case consumer purchase less quantity of commodity at higher price. Therefore consumer moves leftward on the same demand curve.	In this case consumer purchase less quantity of commodity at same price. Therefore consumer shifts leftward on a new demand curve.												
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v	Demand Curve  <p>In diagram B→A shows Contraction of demand</p>	Demand Curve  <p>In diagram A→B shows decrease in demand</p>												

**21. Define slope of demand curve.**

**Ans : - Slope of the Demand Curve** - The slope of the demand curve equals the change in price divided by the change in quantity as the slope is defined as the change in the variable on the Y-axis divided by the change in the variable on the X-axis.

$$\text{Slope of Demand Curve} = \frac{\Delta Y}{\Delta X} = \frac{\text{Change in price}}{\text{Change in demand}}$$

**22. Define price elasticity of demand. Briefly explain the factors affecting price elasticity of demand.**

**Ans: - Price elasticity of demand** – It measures the degree of responsiveness of the quantity demanded of a good to a change in its price.

**Factors affecting Price Elasticity of demand**

**i) Number of Substitutes** - A commodity will have elastic demand if there are more number of substitutes available. E.g.- Pepsi, Coca-Cola, and Frooti etc. A commodity having less number of substitutes, such as salt will have inelastic demand.

**ii) Nature of the Commodity**- Generally, the demand for necessities is inelastic (less elastic) and demand for luxuries is elastic (more elastic). This is so because certain goods which are essential to life will be demanded at any price, whereas goods meant for luxuries can be disposed off easily if they appear.

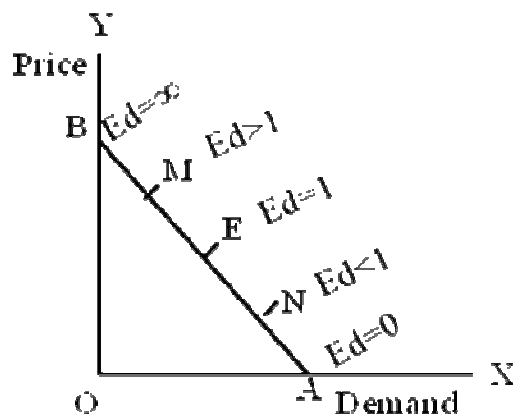
**iii) Different uses of commodity**- If the commodity has different uses its demand will be elastic.

**iv) Habits**- Commodities in habit of the consumers have less price elasticity.

**v) Level of income** - If consumer belongs to richer section then his demand will not be affected by change in price, hence demand will be inelastic.

**23. What will be the elasticity of demand at different points of a straight line demand curve? Explain with the help of a diagram.**

**Ans :-** Suppose a straight line demand curve intersect X axis and Y axis at point A and B respectively. E is the the midpoint of demand curve.



In above diagram applying the formula-

$$Ed = \frac{\text{Lower segment}}{\text{Upper segment}}$$

$$\begin{aligned} \text{i) } Ed \text{ at point B} &= \frac{LS}{US} \\ &= \frac{AB}{0} = \infty \end{aligned}$$

**Thus Elasticity of demand at point where a straight demand curve intersects Y-axis is infinity.**

$$\begin{aligned} \text{ii) } Ed \text{ at point M} &= \frac{LS}{US} \\ &= \frac{MA}{MB} \end{aligned}$$

Since  $MA > MB$

Therefore  $Ed > 1$

$$\begin{aligned} \text{iii) } Ed \text{ at point E} &= \frac{LS}{US} \\ &= \frac{EA}{EB} \end{aligned}$$

Since  $EA = EB$  (as E is midpoint of demand curve)

Therefore  $Ed = 1$

$$\begin{aligned} \text{iv) } Ed \text{ at point N} &= \frac{LS}{US} \\ &= \frac{NA}{NB} \end{aligned}$$

Since  $NA < NB$

Therefore  $Ed < 1$

$$\begin{aligned} \text{v) } Ed \text{ at point A} &= \frac{LS}{US} \\ &= \frac{0}{AB} \\ &= 0 \end{aligned}$$

**Thus Elasticity of demand at point where a straight demand curve intersects X-axis is zero.**

## **24. Explain the relationship between price elasticity of demand and the total expenditure.**

**Ans:** - Price elasticity of demand and total expenditure are related as follows -

**(i) When demand is elastic ( $Ed > 1$ )** - In this case with a fall in the price of the commodity, total expenditure increases and with a rise in its price, total expenditure decreases. It means due to change in price and total expenditure changes in inverse direction.

**(ii) When elasticity is unitary ( $Ed = 1$ )** - In this case with fall or rise in the price of the commodity makes no change in total expenditure.

**(iii) When demand is inelastic ( $Ed < 1$ )** - In this case with a fall in the price of a commodity, total expenditure decreases and with a rise in its price, total expenditure increases. It means price and total expenditure change in same direction.

## 25. Define Supply. Explain any four determinants of supply of a commodity.

**Ans:- Supply-** The quantity of a commodity that the producer is willing to sell at a given price during a given period of time is called supply.

The factors affecting supply are -

**i) Technological changes** - Technological advancement in the field of production leads to decrease the cost of production and increases the production and supply of good. The technological progress shifts supply curve to the right and vice versa.

**ii) Price of other goods** - With the fall in the price of other goods, supply of good increase. The supply curve shifts to the right and vice versa.

**iii) Change in input price** - If the price of factor inputs decreases it decreases the cost of production and increase the production & supply of good. The supply curve shifts to the right and vice versa.

**iv) Change in the excise tax rate** - If the excise duty decreases, it decreases the production cost and increases the production & supply of good. The supply curve shifts to the right and vice versa.

## 26. Distinguish between

a) Extension of supply and Contraction of supply

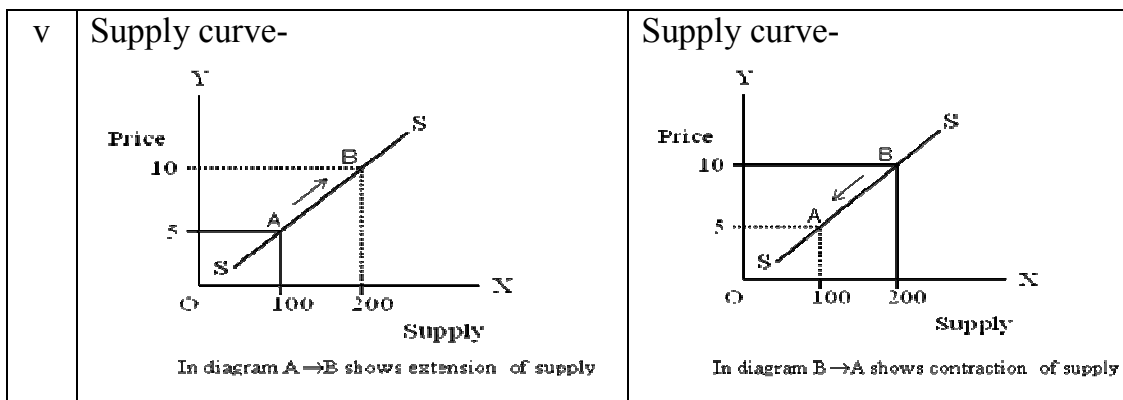
b) Change in supply' and 'Change in quantity supplied' of a commodity.

**Ans:-**

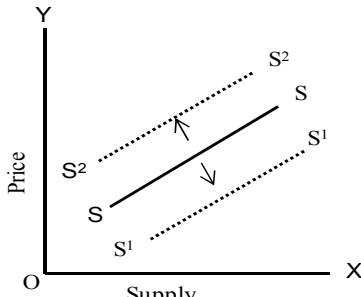
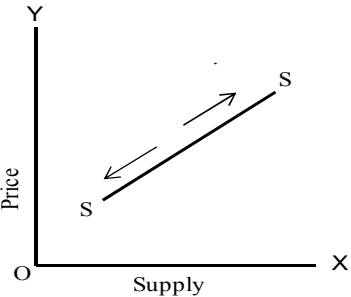
a) Difference between Extension of supply and Contraction of supply

Sl. No	Extension in Supply	Contraction of Supply												
i	Other things remain constant, if supply of commodity increases due to increase in its price, is called extension of supply.	Other things remain constant, if supply of commodity decrease due to decrease in its price, is called contraction of supply.												
ii	The main cause is increase in price of commodity.	The main cause is decrease in price of commodity.												
iii	It results rightward movement along a supply curve.	It results leftward movement along a supply curve.												
iv	Supply Schedule - <table border="1" style="margin-left: 20px;"> <thead> <tr> <th>Price (₹)</th> <th>Supply (Units)</th> </tr> </thead> <tbody> <tr> <td>5</td> <td>100</td> </tr> <tr> <td>10</td> <td>200</td> </tr> </tbody> </table>	Price (₹)	Supply (Units)	5	100	10	200	Supply Schedule - <table border="1" style="margin-left: 20px;"> <thead> <tr> <th>Price (₹)</th> <th>Supply (Units)</th> </tr> </thead> <tbody> <tr> <td>10</td> <td>200</td> </tr> <tr> <td>5</td> <td>100</td> </tr> </tbody> </table>	Price (₹)	Supply (Units)	10	200	5	100
Price (₹)	Supply (Units)													
5	100													
10	200													
Price (₹)	Supply (Units)													
10	200													
5	100													





**b) Difference b/w Change in supply and Change in quantity supplied**

Sl. No.	Change in Supply	Change in Quantity Supplied												
i	Keeping price constant, if supply of a commodity increases or decreases due to change in factors other than price, is called change in supply.	Other things remain constant, when supply of commodity rises or falls due to change in price, is called change in quantity supplied												
ii	The main causes are - change in technology, change in prices of factors of production etc.	The main cause is change in price (increase or decrease in price) of commodity.												
iii	It is also called <b>shift of supply curve</b> .	It is also called <b>movement along a supply curve</b> . (Leftward movement is due to decrease in price and rightward movement is due to increase in price.)												
iv	<p>Supply Schedule -</p> <table border="1" style="margin-left: auto; margin-right: auto; border-collapse: collapse;"> <thead> <tr> <th style="padding: 5px;">Price (₹)</th> <th style="padding: 5px;">Supply (Units)</th> </tr> </thead> <tbody> <tr> <td style="text-align: center; padding: 5px;">10</td> <td style="text-align: center; padding: 5px;">100</td> </tr> <tr> <td style="text-align: center; padding: 5px;">20</td> <td style="text-align: center; padding: 5px;">200</td> </tr> </tbody> </table>	Price (₹)	Supply (Units)	10	100	20	200	<p>Supply Schedule -</p> <table border="1" style="margin-left: auto; margin-right: auto; border-collapse: collapse;"> <thead> <tr> <th style="padding: 5px;">Price (₹)</th> <th style="padding: 5px;">Supply (Units)</th> </tr> </thead> <tbody> <tr> <td style="text-align: center; padding: 5px;">5</td> <td style="text-align: center; padding: 5px;">100</td> </tr> <tr> <td style="text-align: center; padding: 5px;">10</td> <td style="text-align: center; padding: 5px;">200</td> </tr> </tbody> </table>	Price (₹)	Supply (Units)	5	100	10	200
Price (₹)	Supply (Units)													
10	100													
20	200													
Price (₹)	Supply (Units)													
5	100													
10	200													
v	<p>Supply curve</p> 	<p>Supply curve</p> 												

**27. Define price elasticity of supply. How is it measured by geometric method? (In case of a straight line supply curve).**

**Ans :- Price elasticity of supply** - It measures degree of responsiveness of supply of a commodity due to a change in its price.

In other words, price elasticity of supply of a commodity can be expressed as a ratio of percentage (proportionate) change in supply of a commodity to percentage change in price.

$$E_s = \frac{\% \text{ change in quantity supplied}}{\% \text{ change in price}}$$

Let

Initial price = P

Final price = P<sub>1</sub>

Initial quantity supplied = Q

Final quantity supplied = Q<sub>1</sub>

Change in quantity ( $\Delta Q$ ) = Final Quantity Supplied - Initial Quantity Supplied  
= Q<sub>1</sub> - Q

Change in price ( $\Delta P$ ) = Final price - Initial price  
= P<sub>1</sub> - P

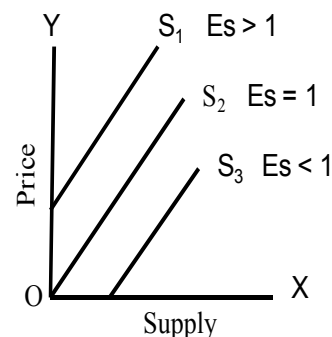
$$E_s = \frac{\frac{\Delta Q}{Q} \times 100}{\frac{\Delta P}{P} \times 100}$$

$$= \frac{\Delta Q}{Q} \times \frac{P}{\Delta P}$$

$$E_s = \frac{\Delta Q}{\Delta p} \times \frac{P}{Q}$$

**According to geometric method** –On a straight line supply curve elasticity of supply can be measured as follows-

- When a straight line supply curve touches the OY axis in its positive range,  $E_s > 1$ . In diagram S<sub>1</sub> curve.
- When a straight line supply curve passes through the origin,  $E_s = 1$ . In diagram S<sub>2</sub> Curve.
- When a straight line supply curve touches the OX-axis in its positive range,  $E_s < 1$ . In diagram S<sub>3</sub> curve.



**28. Define the following-**

- Market Period**
- Production Function.**
- Marginal Physical Product.**
- Normal Profit**

**Ans:-**

**a) Market period** – It is defined as a very short time period in which supply of commodity cannot be changed by changing the unit of factors of production. In this case all the factors of production remain constant.

**b) Production Function-** It shows technological relationship between physical inputs and physical outputs.

It can be written as follows:

$Q = f(f_1, f_2, f_3 \dots f_n)$ . Where Q is physical quantity produced and  $f_1, f_2, f_3 \dots f_n$  are the physical quantities of different factors of production used.

**c) Marginal Physical Product** - The change in total physical product (TPP) by employing an additional unit of variable factor is called Marginal Physical Product (MPP).

$$\text{MPP} = \text{TPP}_n - \text{TPP}_{n-1}$$

**d) Normal Profit** - Normal profit is the minimum amount of profit which is essential to keep an entrepreneur in production in the long run.

**29. What do you mean by returns to a factor? Explain the reasons for increasing returns to a factor.**

**Ans: - Returns to a factor** means keeping other inputs constant, the change in physical output by increasing only one physical input.

**Causes of increasing return:-** Following factors lead to increasing returns to a factor-

- i. **Indivisibility of the factors** - Increase in units of variable factor leads to better and fuller utilisation of fixed factor. This causes the production to increase at a rapid rate.
- ii. **Efficient utilisation of variable factor** - When more units of variable factor are employed with fixed factor, then variable factor is utilised in more efficient way.
- iii. **Optimum combination of factors** - In the beginning when quantities of a variable factors are applied to fixed factors, the system moves towards achievement of optimum combination of factors because then underutilised fixed factors (building, machine, land etc) are better and more fully used. Thus lead to increasing returns.
- iv. **Specialisation-** With more use of labour, process based division of labour and specialisation becomes possible which increases efficiency and productivity.

**30. Explain the likely behaviour of Total Product and Marginal Product when only one input is increased while all other inputs are kept unchanged.**

**Or**

**Briefly explain law of variable proportion or returns to variable factor.**

**Ans: - Law of variable proportion or returns to variable factor** - This law state that keeping other factors of production constant, when only one variable factor is increased, in the beginning total physical product increases at an increasing rate, then increases at a decreasing rate and ultimately decline.

This law is applicable in short period only.

This law has three phases-

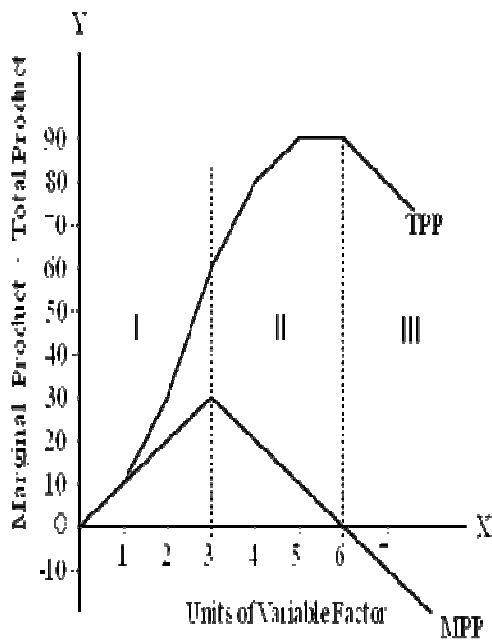
**I- Increasing returns to a factor** - In this phase MPP increases so TPP increases at an increasing rate. Reasons for increasing returns to a factor are - better utilisation of fixed factor, increase in efficiency of variable factor, indivisibility of fixed factors.

**II- Diminishing returns to a factor** - In this phase MPP decreases but positive so TPP increases at decreasing rate .This phase ends when MPP is zero & TPP is maximum. Reasons for diminishing returns is that factors of production are imperfect substitutes of each other and after optimum combination of factors when more and more units of variable factors are increased, pressure of production start falling on fixed factors and MPP start decreasing.

**III-Negative returns to a factor** - In this phase MPP becomes negative so TPP decreases. It happens when variable factor become too much as compared to fixed factors then coordination between variable and fixed factor become very poor and efficiency of factors decrease.

**Explanation:** The law of variable proportion can be explained with the help of a schedule and a diagram as follows.

Fixed factor Land in acres	Variable factor [Units]	MPP [Units]	TPP [Units]	Phase
1	0	-	0	I
1	1	10	10	
1	2	20	30	
1	3	30	60	
1	4	20	80	II
1	5	10	90	
1	6	0	90	
1	7	-10	80	III



In above table and diagram-

- First unit to third unit MPP increasing so TPP increases at an increasing rate. Therefore it's a phase of increasing return.
- Fourth unit to sixth unit MPP decreasing but positive & TPP increases at decreasing rate. Therefore it's a phase of decreasing return.
- Sixth unit onward MPP become negative & TPP is decreasing. Therefore it's a phase of negative return.

**31. What do you mean by marginal revenue? Explain with the help of an example.**

**Ans: - Marginal Revenue** - The change in total revenue by selling an additional unit of a commodity is called marginal revenue.

It can be obtained by two formulae-

$$MR = TR_n - TR_{n-1} \quad \text{or} \quad MR = \frac{\Delta TR}{\Delta Q}$$

E.g. suppose by selling 10 units of a commodity money received by seller is ₹ 50 and by selling 11 units, he receives ₹ 54 .Then MR will be as follows-

$$\begin{aligned} MR &= TR_n - TR_{n-1} \\ &= TR_{11} - TR_{11-1} \\ &= TR_{11} - TR_{10} \\ &= 54 - 50 \\ &= ₹ 4 \end{aligned}$$

**32. Explain the relationship between average revenue and marginal revenue under perfect competition?**

**Ans: - Relationship between MR and AR under Perfect competition**

Under Perfect Competition the relationship between marginal revenue (MR) and average revenue (AR) can be studied as under-

Under perfect competition price of commodity remain constant therefore average revenue also remain constant as it is always equal to price.

$$AR = P \dots \dots \dots (1)$$

Since price is constant therefore revenue received by selling an additional unit of commodity i.e. marginal revenue will also equal to price which is constant or same.

$$MR = P \dots\dots\dots (2)$$

From equation 1 and 2

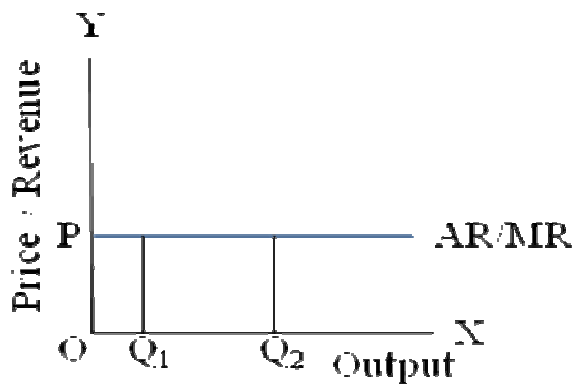
$$AR = P = MR$$

$$AR = MR$$

Thus under perfect competition marginal revenue and average revenue are equal and constant. Therefore AR-MR curve is parallel to X-axis.

We can explain it with the help of a schedule and diagram:

Units of commodity sold	Price (P) (₹)	Total Revenue TR=P×Q (₹)	Marginal Revenue MR=TR <sub>n</sub> - TR <sub>n-1</sub> (₹)	Average Revenue $AR = \frac{TR}{Q}$ (₹)
1	10	10	10	10
2	10	20	10	10
3	10	30	10	10
4	10	40	10	10

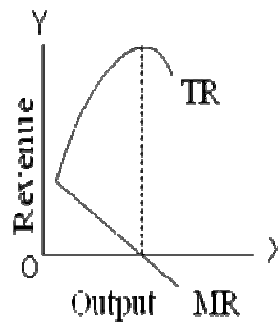


In above diagram AR/MR line shows average revenue –marginal revenue curve.

**33. Explain the relationship between total revenue and marginal revenue.**

**Ans :- Relationship between marginal revenue and total revenue**

- When marginal revenue is positive, total revenue increases.
- When marginal revenue is zero, total revenue is maximum.
- When marginal revenue is negative, total revenue decreases.



**34. What do you mean by total fixed cost (TFC), total variable cost (TVC) and total cost (TC) of a firm? How they are related?**

**Ans – Total Fixed Cost (TFC):-** The total amount of money spends on fixed factors of production is called fixed cost.

It can be obtained by subtracting, total variable cost from total cost

$$TFC = TC - TVC$$

**Total Variable Cost (TVC):-** The total amount of money spends on variable factors of production is called total variable cost.

It can be obtained by subtracting, total fixed cost from total cost

$$TVC = TC - TFC$$

**Total (TC):-** The total amount of money spends on all the factors (fixed and variable) of production is called total cost.

It can be obtained by summing up, total fixed cost and total variable cost

$$TC = TFC + TVC$$

**The relationship among TC, TFC and TVC is as under-**

When output is zero, variable costs are also zero but even then fixed costs are still incurred. Thus at a zero level of output total fixed cost and total variable costs are equal. As output increases total fixed costs remain constant but total costs and total variable costs goes on increasing. An increase in TC indicates an increase in TVC only as TFC remain same. Thus the difference between TC and TVC is equal to TFC.

**35. Distinguish between fixed cost and variable cost.**

**Ans: Difference between fixed cost and variable cost**

Sl. No.	Fixed Cost	Variable Cost
i	The amount of money spent on fixed factors of production is called fixed cost.	The amount of money spent on variable factors of production is called variable cost.
ii	Fixed cost does not change with change in level of output.	Variable cost changes with change in the level of output.
iii	Fixed cost can never be zero even when production is stopped.	Variable cost is zero when production is stopped
iv	<i>E.g.:-</i> Rent of building, salaries of permanent employees etc.	<i>E.g.:-</i> Cost of raw material, wages of temporary labour etc.

**36. Why does the difference between Average Total Cost (ATC) and Average Variable Cost (AVC) decrease with increase in the level of output? Can these two be equal at some level of output? Explain.**

**Ans :-** Average cost is the sum of average fixed cost and average variable cost. Hence

$$ATC (AC) = AFC + AVC$$

$$\text{So, } ATC - AVC = AFC$$

This shows that difference between ATC and AVC is equal to AFC.

AFC is obtained by dividing total fixed cost by output, i.e.  $AFC = \frac{TFC}{Q}$

And total fixed cost (TFC) is constant.

Therefore, with the increase in the level of output, AFC falls.

Thus, the difference between ATC and AVC decreases with increase in output.

No, ATC and AVC cannot be equal at any level of output as gap between them i.e. AFC can never be zero because TFC is constant and positive.

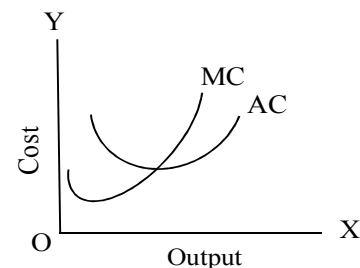
**37. What is the relationship between marginal cost and average cost?**

**Ans :- Relationship between marginal cost and average cost**

(i) When marginal cost is less than average cost, average cost falls.

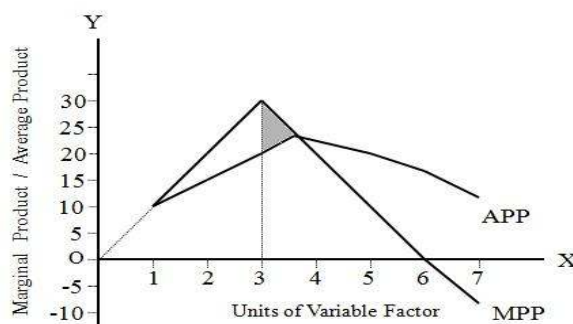
(ii) When marginal cost is equal to average cost, average cost is minimum.

(iii) When marginal cost is greater than average cost, average cost rises.



**38. Is it possible MPP decrease but APP increase? Give reasons to support your answer.**

**Ans :-** Yes, it's possible MPP decrease but APP increase. It happens only when MPP is decreasing but more than APP.



In above diagram shaded areas shows that MPP decreasing but APP increasing as  $MPP > APP$ .



### 39. Why is MC curve in the short run U-shaped?

**Ans: - MC curve is U-shaped** in short run due to operation of law of returns to factors (i.e., law of variable proportion). Initially production is subject to law of increasing returns (i.e. decreasing cost), then law of constant return (i.e. constant cost) and ultimately to law of diminishing return (i.e. increasing cost). As output is increased, MC first falls, reaches its minimum and then rises. Hence, MC curves become U-shaped.

### 40. What is meant by producer's equilibrium? Explain MR-MC Approach of Producer's Equilibrium.

**Ans: - Producer's Equilibrium** - The situation when a producer earns maximum profits is called **producer's equilibrium**.

#### MR-MC Approach of Producer's Equilibrium-

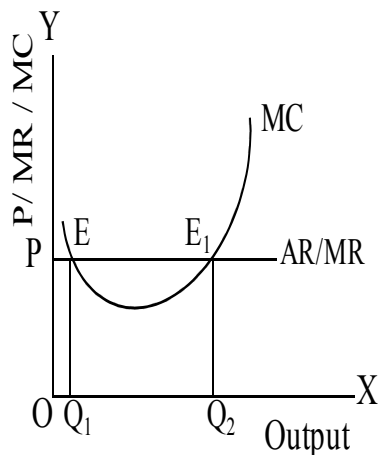
A producer is said to be in equilibrium when he produces such a level of output at which his profit is maximum.

Under perfect competition, Price = MR = AR which is parallel to X axis.

Two conditions must be satisfied to achieve producer's equilibrium. At equilibrium point-

- (i) MR=MC,
- (ii) MC cuts MR from below.

We can explain it with the help of diagram as follows-



In diagram, at point  $E_1$ ,  $MR=MC$  and MC cuts MR from below. As it satisfies both the conditions of equilibrium at this point. So  $E_1$  is equilibrium point and  $OQ_2$  is the equilibrium level of output. If the firm produces less than  $OQ_2$  then profit are not maximise. On the other hand, if firm produces more than  $OQ_2$  then there will be a loss and total profits will be reduced. Thus equilibrium will be at  $E_1$  only where both conditions of equilibrium are satisfied.

### 41. What do you mean by perfect competition? State its main features?

**Ans :- Perfect competition** is a market where there are large numbers of buyers and sellers and sellers sell homogeneous commodity at uniform price.

Under Perfect Competition a firm is only *price taker*.

Main features of perfect competition are as under -

**(i) Large number of buyers and sellers** - Under perfect competition buyers and sellers are in such a large number so that neither a single buyer nor a single seller can influence the market. It is because each seller sells a very small portion of the market supply, similarly the demand of each buyer is also very small in the market.

**(ii) Homogeneous product** - The product sold in the market is homogeneous or identical in all respect i.e. shape, size, colour, composition, etc.

**(iii) Free entry and exit of firms** - Under perfect competition there are no barrier to entry and exit of firms in industry. But entry and exit may take time so it happens only in long runs.

**(iv) Perfect knowledge of market**- In this market all the sellers as well as buyers have the complete information about the market situation. It means they are well aware about the product and its price.

**(v) Perfect mobility** – The factors of production i.e. land, labour, capital and entrepreneur are perfectly mobile. There is no geographical and occupational restriction on their movement. It means factors of production are free to move from one place to another place and one job to another job in which they get better price.

#### **42. What do you mean by monopoly? State its main features?**

**Ans :- Monopoly** is a market situation where there is a single seller of a commodity which has no close substitutes.

Main features of a monopoly market are:

**(i) Single seller**- Under monopoly there is only seller of commodity in the industry, so the difference between firm and industry get vanished.

It means the monopolist has full control over the supply and price of commodity.

**(ii) No close substitute** - The monopolist produces a distinct product which has no close substitute in the market. Therefore the monopoly firm has no fear of competition from any other commodity.

**(iii) Barriers on entry** - There are strong or significant barrier to the entry of new firms. These barriers may be legal barriers like patent right or licensing etc.; as a result monopolist firm can earn abnormal profit in the long run.

**(iv) Price discrimination**- When a monopolist charge different prices from different buyers for the same product is called price discrimination. It's a distinct feature of monopoly market.

**(v) Independent price policy** - In monopoly, firm and industry are same so the firm has complete control over the output and it fixes its price by itself. Thus firm is price market in monopoly

**43. What is meant by monopolistic competition? Write its main features.**

**Ans: - Monopolistic Competition** - It's a market situation where there are large numbers of firms which sell closely related but differentiated product such as market of toothpaste, soap etc.

**The main features of monopolistic competition are as under:**

- Large Number of Buyers and Sellers: There are large number of firms but not as large as under perfect competition.
- Free Entry and Exit of Firms
- Product Differentiation
- High Selling Cost
- Lack of Perfect Knowledge
- Less Mobility
- More Elastic Demand

**44.Explain the implication of the feature product differentiation under Monopolistic Competition and freedom of entry & exit of firms under perfect competition.**

**Ans: - Product differentiation under Monopolistic Competition** - It is a distinct feature of monopolistic market. It means that buyers differentiate between the products produced by different firms. Therefore, they are willing to pay different prices for the products of different firms. Different groups of buyers prefer products of different firms. This gives an individual firm some monopoly power, i.e. power to influence the demand for its product by changing price.

**Free entry and exit of firms under perfect competition** - It means that there is no barrier for entry and exit of firms in the industry. This freedom ensures that firms earn just the normal profits in the long run.

If the existing firms earn above-normal profits, new firms enter in the industry, raise supply, which brings down the price. The profits fall till each firm is once again earning only the normal profits.

If the existing firms are having losses, the firms start leaving, supply falls and price goes up. The price continues to rise till the losses are wiped out and firms are just earning normal profits.

**45. What is meant by oligopoly? Define Collusive, Non-Collusive, Perfect and Imperfect oligopoly.**

**Ans: - Oligopoly** is a market structure in which there are few large sellers of a commodity, which sell homogenous and differentiated product. Under this market situation firms are interdependent.

The Oligopoly is the most common market structure. The main features of oligopoly are - few firms, Interdependence of firms, Barriers to entry, Differentiated products, advertising is often important.

**Perfect Oligopoly** - If the firms produce homogeneous products, it is called perfect oligopoly.

**Imperfect Oligopoly** - If the firms produce differentiated products, it is called imperfect oligopoly.

**Collusive Oligopoly** is one in which the firms cooperate with each other in deciding price and output.

**Non Collusive Oligopoly** is one in which firms compete with each other.

**46. Define equilibrium price. Explain how price is determined under perfect competition with the help of schedule and a diagram.**

**Ans: - Equilibrium price** is the price at which demand and supply of commodity are equal.

Under perfect competition the market equilibrium is determined by equality between quantity demanded and quantity supplied of a commodity in the industry.

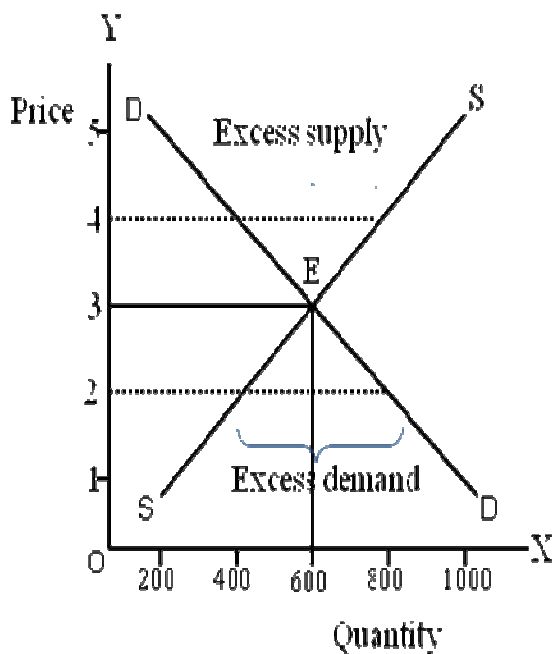
It means at equilibrium point - **Quantity Demanded = Quantity Supplied**

The price determined at equilibrium point is called *equilibrium price*.

The price has a tendency to persist. If at a price, market demand is not equal to market supply there will be either excess demand or excess supply and the price will have tendency to change until it reach a point where demand and supply are equal.

**Explanation** – We can show it with the help of demand-supply schedule and curve.

Price (₹)	Market Demand (Units)	Market Supply (Units)	Equilibrium
1	1000	200	Excess demand
2	800	400	
3	600	600	Market Equilibrium
4	400	800	Excess supply
5	200	1000	

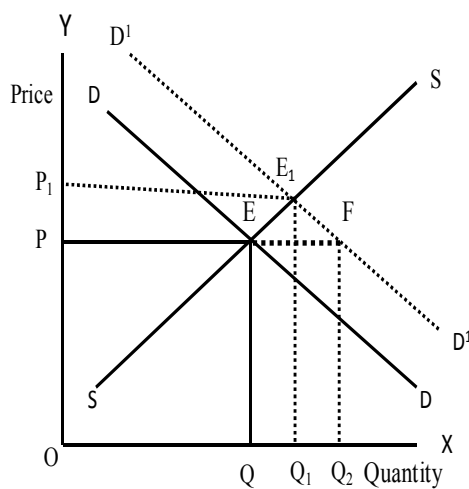


In the above schedule and diagram market equilibrium is established at a price of ₹ 3 per unit, because at this price both the market demand and market supply are equal. This is the price which has a tendency to persist. If a price less than the equilibrium price, suppose it is ₹ 2 per unit. At this price market demand is greater than market supply. It is called an excess demand situation.

In this case the buyers will not be able to buy all what they want to buy. The pressure of excess demand will push the market price up. This will have two effects - Extension of supply and contraction of demand. The tendency of supply going up and demand going down will continue till market demand and supply become equal. This is achieved at price ₹ 3 per unit where equilibrium is restored and vice versa.

#### 47. How does an increase in demand of a commodity affect its equilibrium price? Explain with the help of a diagram.

**Ans :-** An increase in demand of a commodity results in a rightward shift of demand curve which lead to increase in price. It can be explain by diagram as follow-



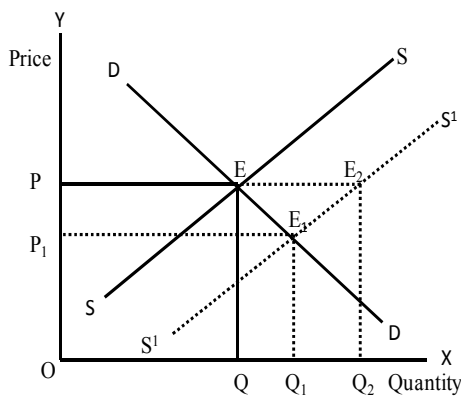
In the *diagram*, demand and supply of good are equal at point E. So E is equilibrium point. At this point OP is equilibrium price and OQ is equilibrium quantity. When demand increases, demand curve shifts to right i.e.  $D^1 D^1$ , then at OP price there is EF excess demand. This results competition among buyers which will raise the price. At a higher price, quantity demanded will fall and quantity supplied will increase, resulting in upward movement along new demand curve and given supply curve.

This reduces the gap between quantity demanded and quantity supplied. These changes will continue till we reach the new equilibrium point  $E_1$  where quantity demanded is equal to quantity supplied.

Now  $OP_1$  is new equilibrium price. Since new equilibrium price [ $OP_1$ ] is higher than the old equilibrium price [ $OP$ ] which shows that equilibrium price has increased.

**48. How does an increase in the supply of a commodity affect its equilibrium price? Explain with the help of a diagram.**

**Ans :-** An increase in supply of a commodity results in a rightward shift of supply curve which lead to decrease in price. It can be explain by diagram as follow - We can explain it with the help of following diagram:



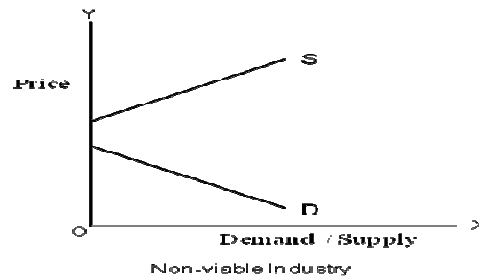
In diagram, demand and supply of good are equal at point E. So E is equilibrium point. At this point OP is equilibrium price and OQ is equilibrium quantity. When supply increases new supply curve  $S^1S^1$  shifts to right, it shows that at OP price, there is  $EE_2$  excess supply. This excess supply results competition among the sellers leading to fall in the price.

A fall in price results in rise in quantity demanded (extension of demand) and fall in quantity supplied (contraction of supply). These changes will continue till quantity demanded and supplied are equal at point  $E_1$ . So  $E_1$  is new equilibrium point and  $OP_1$  is new equilibrium price.

Since  $OP_1 < OP$  which shows that equilibrium price has decreased.

**49. What do you mean by non-viable industry? Explain with the help of an example.**

**Ans: - Non-viable industry-** An industry in which production cost is very highly and firm is unable to produce the good. At a given price no buyer is ready to purchase the product. In this case demand curve and supply curve do not intersect each other at any positive level of output and supply curve lies above the demand curve.



**50. Answer the following-**

- i) Define Control Price or Price Ceiling. What are its implications? Write in brief.**
- ii) What is Support price (Floor Price)?**
- iii) Give one example each of government direct intervention and indirect intervention in market mechanism.**

**Ans: -**

**I) Control Price (Price Ceiling):-** When government fixes price of a product at a level lower than the equilibrium price, the price is called control price (or price ceiling). Ceiling means the maximum limit. Producers cannot sell their products above this price.

Control price or ceiling price is the maximum price that can be charged for a commodity. This is done so that necessary goods become available to common people.

Since control price is lower than the equilibrium price, it leads to excess demand and short supply. Suppose, the equilibrium price of sugar in a free market is ₹ 40 per kg at which both demand and supply of sugar are equal, i.e., 50 tones. When government fixes price at ₹ 35 per kg, the demand for sugar rises to 60 tones and supply falls to 40 tones, this create disequilibrium.

The implication or consequence of price control can be any of the following:

- a) **Rationing:** It is a system of distributing essential goods in limited quantities at control prices.
- b) **Black market:** It is a market in which controlled goods are sold unlawfully at prices higher than the price fixed by the government.
- c) **Dual marketing:** It is a system of having two prices for the same commodity at the same time.

**II) Support price (Floor Price):-** When government fixes price of a product at a level higher than equilibrium price, it is called support price (or floor price). Floor means the lowest limit. Support price or floor price is the minimum price at which a commodity can be purchased. As a result, the supply becomes in excess of demand.

Support price is fixed to safeguard the interests of producers.

This price is sometimes called floor price because it is the minimum price fixed by the government. Government generally fixes floor price for mostly agricultural products like food grains, sugar, etc.

**III)** Fixing prices of a product by the government directly is an example of **direct intervention**. The levying of taxes and granting of subsidies which indirectly change the market price of a product is an example of **indirect intervention**.

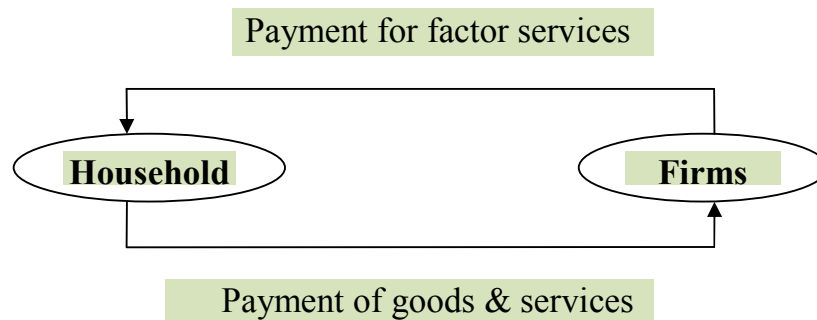
**51. What do you mean by circular flow of income? Briefly explain its various types.**

**Ans: - Circular flow of income-** The flow of income among different sectors of the economy is called circular flow of income.

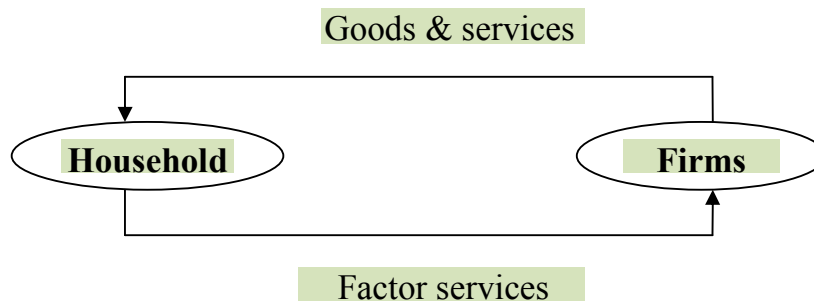
Circular flow is of two types: money flow and real flow

**Money flow** – It refers to the flow of money in the form of factor payment and consumption expenditure.

In other words money flow refers to the flow of factor payments from firms to household for their factor services and corresponding flow of consumption expenditure from household to firm for purchase of goods and services produced by the firms. It is also called nominal flow.



**Real flow-** It refers to the flow of factor services from household to firms and the corresponding flow of goods and services from firms to households. It is also known as product flow.





## 52. What do you mean by consumption and capital goods?

**Ans :- Consumption Goods-** The goods which are purchased by consumer to satisfy their wants are called consumption goods. These goods satisfy human wants directly such as pen, pencil, bread, butter etc.

These goods can be further divided into following categories-

**Durable Goods:** These are the goods which can be used again and again in consumption over a long period of time. Such as T.V., Computer, Fan etc.

**Semi-durable Goods:** The goods which can be use for limited period of time are known as Semi durable Goods. These goods have a life span of around one year. Such as clothes, crockery, shoes etc.

**Non-durable Goods:** The goods which are used up in a single act of consumption are called non durable Goods.

**Services** –Services are produced and consumed simultaneously; it means there is no time gap between their production and consumption. These are rendered for direct consumption. Such as services of doctor, teacher etc.

**Capital goods** - The goods which help in production of other goods and services and added in the capital stock of a country at the end of an accounting year are called capital goods. It includes durable goods like car, fridge, road etc. Stock of semi finished, finished goods and raw material are also part of it.

## 53. What do you mean by investment or capital formation? Name its various concepts.

**Ans: - Investment or Capital Formation-** The addition in the capital stock of a country is called investment or capital formation. E.g. construction of building, purchase of machinery, addition to the inventories of goods etc.

Investment can be of two types-

**1- Gross Investment:** The total addition made to the capital stock of economy in a given period is termed as gross investment. It consists fixed assets and unsold stock.

**2-Net Investment:** The actual addition made to the capital stock of economy in a given period of time is called net investment. It can be obtained by subtracting depreciation or consumption of fixed capital from gross investment.

$$\text{Net Investment} = \text{Gross Investment} - \text{Depreciation}$$

## 54. Briefly explain the production method of measuring national income.

**Ans: - Production Method:** This method measures the national income by taking the value of final goods and services produced by the different industrial sectors of the economy.

**Steps of Measurement:**

**(1) Classify all the production units** located in the domestic (or economic) territory into distinct industrial sectors. The production units are classified into primary, secondary and tertiary sectors.

**(2) Estimate  $NVA_{FC}$**  of each industrial sector by taking the following sub-steps-

(a) Estimate gross value of output: Gross value of output (GVO) is the total worth of goods produced .It can be estimated in two ways:

(i) As sum of sales and net addition to stocks

$$\text{Value of output} = \text{Sales} + \text{change in stock}$$

Where, Change in stock = Closing stock – Opening stock

(ii) Quantity of output multiplied by price.

$$\text{Value of output} = \text{Price} \times \text{Quantity}$$

(b) Estimate value of intermediate consumption and deduct the same from gross value of output (GVO) to arrive at  $GVA_{MP}$ .

$$\text{Gross value added (GVA}_{MP}) = \text{GVO} - \text{Intermediate consumption}$$

(c) Estimate consumption of fixed capital (depreciation) and deduct it from  $GVA_{MP}$  to arrive at  $NVA_{MP}$ .

$$NVA_{MP} = GVA_{MP} - \text{consumption of fixed capital (depreciation)}$$

(d) Find out net indirect tax by subtracting subsidies from indirect taxes (NIT= indirect tax – Subsidies) and deduct it from  $NVA_{MP}$  to arrive at  $NVA_{FC}$  of an industrial sector.

$$NVA_{FC} = NVA_{MP} - \text{Net Indirect Tax (NIT)}$$

**(3) Take the sum of  $NVA_{FC}$  of all the production units of all the industrial sectors** of the economy to get  $NDP_{FC}$ .

$$NDP_{FC} = \Sigma NVA_{FC}$$

**(4) Estimate net factor income from abroad** and add the same to  $NDP_{FC}$  to get the  $NNP_{FC}$  or national income.

$$NNP_{FC} \text{ (N.I)} = NDP_{FC} + \text{Net factor income from abroad (NFIFA)}$$

**Precautions** : While estimating national income by the production method / value added method the following precautions must be taken:

- (1) Avoid double counting of output.
- (2) Value of own-account production should be included in total output.
- (3) The value of intermediate goods should not be included.
- (4) Do not include sale of second hand goods.

**55. What is double counting? How can it be avoided?**

**Ans: - Double Counting** – If the value of an item is estimated more than one time in estimation of national income is called double counting. It leads to over estimation of national income.

It can be avoided by two ways-

- i) By taking the value added by each enterprise
- ii) By taking the value of final product

**56. What do you mean by stock and flow variable?**

**Ans: - Stock** -The economic variables that are measured at a particular point of time are called stock variables. Stock is static concept. It has no time dimensions. **E.g.** bank balance as on 1<sup>st</sup> Oct 2011 is ₹5000.

**Flow**-The economic variables that are measured during a period of time are called flow variables. Flow is a dynamic concept. It has time dimensions. **E.g.** Interest earned on bank deposits for 1 year, i.e. from 1<sup>st</sup> April 2011 to 31<sup>st</sup> March 2012.

**57. Distinguish between domestic product and national product.**

**Ans: - Difference between domestic product and national product**

Sl. No.	Domestic Product	National Product
I	Domestic product is the money value of all the final goods and services produced within domestic territory of a country during a financial year.	National product is the money value of all the final goods and services produced by the normal residents of a country during a financial year.
ii	It includes the income of all the residents of the country.	It includes the income of only normal residents of the country.
iii	Net factor income from abroad (NFIFA) is not included in it.	Net factor income from abroad (NFIFA) is included in it.

**58. Distinguish between Factor income and transfer income.**

**Ans: - Factor income and transfer income**

Sl. No.	Factor Income	Transfer Income
i	The amount of money that a factor of production earns by rendering its factor service in production process is called factor income.	The amount of money that an individual receive without providing any service in return is called factor income.
ii	It's an <i>earned</i> concept.	It's a <i>receipt</i> concept.
iii	It's a <i>bilateral</i> concept.	It's a <i>unilateral</i> concept.

iv	It is <b><i>included</i></b> in national income and domestic income.	It is <b><i>not included</i></b> in national income and domestic income.
v	E.g. Rent, interest, wages and profit	E.g. Scholarship, old age pension, unemployment allowance etc.

### 59. Distinguish between Intermediate product and final product.

**Ans:- Difference between Intermediate product and final product**

Sl. No.	Intermediate goods	Final goods
i	The goods which are purchased for resale or further production are called Intermediate goods.	The goods which are meant for final consumption and investment are called final goods.
ii	These goods lie within the production boundary so further value can be added in these good.	These goods lie out of the production boundary so further value cannot be added in these goods.
iii	These goods are not included in estimation of national income.	These goods are included in estimation of national income.

### 60. Distinguish b/w National income and net national disposable income.

**Ans: - Difference b/w National income and net national disposable income**

Sl. No.	Net National Product at factor cost [ $NNP_{FC}$ ] or National Income	Net National Disposable Income (NNDI)
i	$NNP_{FC}$ is the money value of all the final goods and services produced by the normal residents of a country during a financial year.	NNDI is the income of residents of a country from all sources (factor income & transfer income) which they can freely spend on their consumption and saving.
ii	It includes only factor income.	It includes factor income as well as transfer income.
iii	Net current transfers from rest of the world are not included in it.	Net current transfers from rest of the world are included in it.
iv	It's a narrow concept as it is included in National Disposable Income.	It's a broader concept as it includes National Income in it

### 61. Answer the following-

**a) When will the domestic income be greater than the national income?**

**Ans: -** If net factor income from abroad (NFIFA) is negative.

**b) Why are net exports (X-M) a part of domestic income, and not a part of NFIFA?**

**Ans:** - Exports are goods produced within the domestic territory so treated as a part of domestic income.

**62. Will the following factor incomes be included in domestic factor income of India? Give reasons for your answer.**

- (i) Compensation of employees to the residents of Japan working in Indian embassy in Japan.
- (ii) Profits earned by a branch of foreign bank in India.
- (iii) Rent received by an Indian resident from Russian embassy in India.
- (iv) Profits earned by a branch of State Bank of India in England.

**Ans :- (i)** Yes, It will be included in domestic factor income of India because the Indian embassy in Japan is a part of domestic territory of India.

**(ii)** Yes, It will be included in domestic factor income of India because the foreign bank is located in the domestic territory of India.

**(iii)** No, It will not be included in domestic factor income of India because Russian embassy in India is not a part of domestic territory of India.

**(iv)** No, It will not be included in domestic factor income of India because branch of State Bank of India which is earning profit is in England which is not a part of domestic territory of India.

**63. Define Private income, personal income and personal disposable income.**

**Ans :- Private income**-The income of household and private corporate sector from all sources i.e. factor income and transfer income is called private income.

Private Income = Net domestic product accruing to private sector  
 + Net factor income from abroad  
 + Net current transfer from Government  
 + Net current transfer from rest of the world  
 + Interest on National Debt

**Personal income** -The income of households from all sources i.e. factor income and transfer income is called personal income.

Personal income = Private Income  
 - Corporation tax  
 - Corporate Savings or Undistributed profits  
 or Retained Earnings of private corporate sector

**Personal disposable income-** The income of households from all sources i.e. factor income and transfer income which they can freely spend on their consumption and savings is called personal disposable income.

Personal disposable income = Personal income

- Direct Personal tax

-Misc. Receipts of the govt. Admn department

#### **64. What do you mean by National Disposable income?**

**Ans:- National Disposable income** - It is the income of normal resident of a country from all the sources (Earned Income as well as transfer payment from abroad) which they can freely spent on their consumption and saving during a year.

It has two concepts-

Net National disposable income (NNDI) =  $NNP_{MP}$  + Net current transfer from abroad

Gross National disposable income (GNDI) =  $GNP_{MP}$  + Net current transfer from abroad

#### **65. What is meant by gross domestic product? Explain any three limitations of gross domestic product as a measure of economic welfare.**

**Ans :- Gross domestic product (GDP)** refers to the money value of all the final goods and services produced with in domestic territory of a country during a financial year inclusive of consumption of fixed capital or depreciation.

Welfare means sense of material well being among the people. This depends upon greater availability of goods and services. So it may be concluded that higher level of GDP is an index of greater well being of people. But this generalisation is not correct due to some limitations.

#### **Limitations of GDP as a measure of economic welfare-**

i) **Distribution of GDP-** If with increase in GDP inequality of income increase, poor become poorer while rich become richer. This may lead to decline in welfare even though GDP has increased.

ii) **Non-monetary transactions-** GDP remains underestimated as non-monetary transactions like services of housewife, barter exchanges, enjoyment from hobbies like gardening, painting etc. are not included in GDP. Although they increase economic welfare.

iii) **Composition of GDP-** If GDP increases due to more production of war goods like weapons, tanks etc. it will not increase economic welfare.

iv) **Externalities-** Externalities refer to the benefits (or harms) a firm or an individual causes to another for which they are not paid (or penalized). Externalities do not have any market in which they can be bought and sold. Such as carrying out the production of refinery may also be polluting the nearby river and create pollution. This may cause harm to the people who use the water of the river. Such harmful effects that the refinery is inflicting on others, for which

it does not have to bear any cost, are called externalities. Therefore, if we take GDP as a measure of welfare of the economy we shall be overestimating the actual welfare. This was an example of negative externality. There can be cases of positive externalities as well. In such cases GDP will underestimate the actual welfare of the economy.

**66. What do you mean by barter system? What are its main difficulties? How money overcome the problem of barter system? Explain**

**Ans: - Barter System** implies direct exchange of goods against goods without the use of money. It is also called *C-C economy*, i.e. Commodity-for-Commodity exchange economy. E.g. When a weaver gives cloth to the farmer in return for getting wheat from him, it is called barter exchange.

**Main drawback of barter system are-**

- i) Lack of double coincidence of wants
- ii) Lack of common measure
- iii) Lack of divisibility
- iv) Lack of storability
- v) Problem of deferred payment

**Money has solved the problem of barter exchange in the following ways:**

- a) Money as a medium of exchange solves the problem of lack of double coincidence of wants.
- b) In terms of money the value of other goods can be expressed.
- c) Money is of a manageable size and shape, unlike some barter standards, such as cattle.
- d) The value of money changes less where as bartered goods may lose their value after some time.
- e) In term of money future payments can be easily made as value of money changes less.

**67. What do you understand by double coincidence of wants?**

**Ans: - Double coincidence of wants** is the situation in which both parties agree to sell and buy each other's commodities. What a person desires to sell is exactly what the other wishes to buy. This problem exists in case of the barter system of exchange.

**68. What is money? State the four functions of money.**

**Ans: - Money** is anything that is generally accepted by people of a country as a medium of exchange and measure of value.

**Functions of Money-**

- i) Medium of exchange-** People can sale and purchase (exchange) goods and services through money.
- ii) Measure of Value (Unit of value)-** The values of different goods and services can be expressed in term of money

**iii) Standard of deferred payments-** Future transactions or payments can be made in terms of money.

**iv) Store of value -** The money has a quality of storability .So value of goods can be stored in term of it for long period of time.

**69. Define money supply. State two components of money supply.**

**Ans:- Money supply** is the stock of coin, currency and demand deposits held with public at a particular point of time in an economy.

The main components of money supply are-

- (i) Currency held with the public.
- (ii) Demand deposits with commercial banks

**70. What is meant by demand deposits?**

**Ans: - Demand Deposits -** The deposits that can be withdrawn any time by cheque or otherwise are known as demand deposits.

**71. What do you mean by credit creation? Explain the process of Credit (deposit) creation by the commercial banks with the help of numerical example. Also explain its Limitations.**

**Ans: - Credit creation-** The Process of multiplying the deposits by commercial bank is called credit creation.

Money creation or deposit creation or credit creation by the bank is determine by –

- (i) The amount of the initial fresh deposits and
- (ii) The Legal Reserve Ratio (LRR) i.e. the minimum ratio of deposit legally required to be kept as cash by banks.

It is assumed that all the money that goes out of bank is redeposited in to the banks.

Let the LRR be 20% and there is a fresh deposit of ₹ 10,000. As required, the banks keep 20% i.e. ₹ 2,000 as cash. Suppose the bank lend the remaining ₹ 8000. Those who borrow use this money for making payments. As assumed who receive payments put the money back in to the bank. In this way bank receive fresh deposit of ₹ 8,000.

The bank again keeps the 20% i.e. ₹ 1,600 as cash and lends ₹ 6,400 which is also 80% of the last deposit. The money again comes back to the banks leading to a fresh deposit of ₹ 6,400. The money goes on in multiplying in this way, and ultimately total money creation is ₹ 50,000.

Given the amount of fresh deposit and the LRR, the total money creation formula is:

$$\text{Money creation} = \text{Initial deposit} \times \frac{1}{LRR}$$



$$\begin{aligned}
 \text{Money creation} &= 10000 \times \frac{1}{20\%} \\
 &= 10000 \times \frac{1}{20} \times 100 \\
 &= ₹ 50,000
 \end{aligned}$$

**Limitations to credit creation** - There are following limitations to credit creation by banks:

1. The total amount of cash reserves in the banking system. Larger the cash reserves more will be the credit creation.
2. Cash reserve ratio fixed by the central bank. More is the ratio, less is the power to create credit and vice versa.
3. Banking habits of the people of the country- It means banking transactions through cheques, drafts, bills etc. Good banking habit results in keeping smaller amount of cash with the banks and therefore, more can be lent. This will create large credit.

**72. Define Central bank. What are the main functions of central Bank? Explain.**

**Ans: - Central bank:** A central bank is an apex institution of a country that controls and regulates the monetary and financial systems of a country. In India Reserve Bank of India (RBI) is the central bank.

**Main functions** of a central bank are:

**i) Issue of Currency** - The central bank has monopoly of issuing currency in the country. Currency issued by it, is its monetary liability so it has to keep a reserve in the form of gold and foreign securities. It promotes efficiency in the financial system. Firstly, because this leads to uniformity in the issue of currency. Secondly, because it gives Central Bank a direct control over money supply.

**ii) Bankers to Government**- Central bank acts as the bank of central and state governments. It carries out all banking business of the govt. The govt. keeps its cash balances on current a/c with the central bank. It gives loans to central government for short period and manages the public debt of the country. It also transfers government funds and buys and sells securities, treasury bills etc. on behalf of the government.

**iii) Bankers Bank & Supervisor**- As the banker to banks the central bank holds a part of cash reserve of banks, lends them short-term funds and provides them with centralized clearing and remittance facilities.

The central bank supervises, regulates and controls the commercial banks. The regulation of these banks may be related to their licensing, branch expansion,

liquidity of assets, management, merging of banks etc. The control is exercised by periodic inspection of banks and the returns filed by them.

**iv) Controller of Money Supply-** The central bank of the country tries to control the availability of credit in the market with its many tools like CRR, SLR, bank rate, open market operation etc which are also called the instruments of Monetary policy. Central bank regulates the money supply and credit in the best interest of the country.

**v) Lender of Last Resort-** It helps the commercial banks in times of financial difficulties. Scheduled banks can take the loans by rediscounting first class bills or short term approved securities, whenever they do not get funds from any other sources.

### **73.What are open market operations? How do they affect availability of credit?**

**Ans: -** The act of purchase and sale of government bonds/securities in the open market by the central bank is called open market operation.

By selling the securities the central bank takes purchasing from the general public which led to contraction of credit and it reduces the availability of credit in the economy and by buying the securities, the central bank increase additional purchasing capacity in the system which results in expansions of credit.

### **74.What is credit control? How central bank control the credit? Explain.**

**Ans :- Credit Control :-** The Central Bank controls the money supply and credit in the best interests of the economy. The bank does this by taking recourse to various instruments. These are:

**i) Bank Rate Policy:** The bank rate is the rate at which the central bank lends funds to banks. The effect of a change in the bank rate is to change the cost of securing funds from the central bank.

A rise in the bank rate will increase the cost of borrowing from the central bank then causes the commercial banks to increase the interest rates at which they lend. This will discourage businessmen and others from taking loans. Thus reduces the volume of credit and vice versa.

**ii) Open Market Operations:** The act of buying and selling of government securities by the Central Bank from / to the public and banks is called open market operations.

When the Central Bank buys securities from the banks and public it adds to cash balances in the economy .if cash balances are increased in the economy there will be more deposits with the commercial banks which raise the banks' ability to give credit and thus increase the money supply.

When the Central Bank sells securities to the banks and public it withdraws cash balances from the economy. If cash balances are decreased in the economy there

will be lesser deposits with the commercial banks which reduce the banks' ability to give credit and thus decrease the money supply.

**iii) Legal Reserve Ratio (LRR)** – LRR is the minimum ratio of deposits which every bank legally is required to keep as liquefied reserve. There are two components of LLR namely CRR and SLR.

**Cash Reserve Ratio (CRR):** The minimum percentage of their total deposits which is to be kept by commercial banks with the Central Bank is called Cash Reserve Ratio.

A change in CRR affects the power of commercial bank to create the credit. An increase in the CRR reduces the lending capacity of commercial banks to grant loan. Then the commercial banks will increase the interest rates at which they lend. This will then discourage businessmen and others from taking loans. Thus reduces the volume of credit and vice versa.

Thus the CRR should be increased when credit is to be contracted and it (CRR) should be decreased when credit is to be increased.

**Statutory Liquidity Ratio (SLR):** Commercial Banks are required to maintain a specified percentage of their net total in the form of designated liquid assets or cash with themselves. This specific percentage is called Statutory Liquidity Ratio (SLR).

An increase in the SLR reduces the lending capacity of commercial banks to grant loan. Then the commercial banks will increase the interest rates at which they lend. This will then discourage businessmen and others from taking loans. Thus reduces the volume of credit and vice versa.

Thus the SLR should be increased when credit is to be contracted and it (SLR) should be decreased when credit is to be increased.

**iv) Repo Rate:** When the commercial banks are in need of funds for a short period, they can borrow from the Central Bank. The rate of interest charged by the Central Bank on such lendings is called Repo Rate.

Raising Repo Rate makes such borrowings by the commercial banks costly. As such when Repo Rate is raised, banks are also forced to raise their lending rates. This has a negative effect on demand for borrowings from the commercial banks and vice versa.

**v) Reverse Repo Rate:** When the commercial banks have surplus funds they can deposit the same with the central bank and earn interest. The rate of interest paid by the Central Bank on such deposits is called Reverse Repo Rate.

When this rate is raised, it encourages the commercial banks to keep their funds with the central bank. This has the negative effect on the lending capability of the commercial banks and vice versa.

**vi) Margin Requirements:** A margin is the difference between the amount of the loan and market value of the security offered by the borrower against the loan.

If the margin imposed by the Central Bank is 20%, then the bank is allowed to give a loan only up to 80% of the value of the security. By altering the margin requirements, the Central Bank can alter the amount of loans made against securities by the banks. So higher margin requirements decreases the demand for credit and vice versa.

### **75. What is Aggregate Demand? What are its main determinants?**

**Ans: - Aggregate Demand** is the total demand for all the final goods & services by all the consumers in the economy during a year.

The main determinants of Aggregate demand are

**i) Private final consumption demand (C)** - It is the demand of household and non-profit making institutions serving households for durable goods (T.V., Fan etc.), semi-durable goods (clothes, shoes etc.) and non-durable goods (vegetable, bread etc.).

**ii) Government final consumption demand (G)**- It is the expenditure incurred by government on the purchase of goods and services which are needed to provide facilities to the general public, such as, expenditure on road, school, bridge, hospital etc. The level of government expenditure is determined by the government policy.

**iii) Private investment demand (I)**- It refers to the expenditure incurred by the private firm on the purchase of capital goods, such as plant, equipments, buildings, machine etc. The investment is made in the economy in order to increase the production capacity as well as to maintain the present level of production. The rate of interest affects the investment demand inversely.

**iv) Net exports (X-M)**- It is the difference between exports of goods & services and imports of goods & services during the given period of time. It refers to the demand of foreigners for our goods & services over domestic demand for foreign countries goods & services.

### **76. Derive the relationship between APC and APS.**

**Ans: -** The sum of consumption and saving is equal to income.

So,  $C + S = Y$

Dividing both sides by Y we get

$$\frac{C + S}{Y} = \frac{Y}{Y}$$

$$\frac{C}{Y} + \frac{S}{Y} = 1$$

**APC + APS = 1.**

Thus the sum of average propensity to consume and average propensity to save is equal to one.

**77. Define APC and MPC. Why can the value of MPC be not greater than 1?**

**Ans:** - **APC** (Average Propensity to consume) is defined as the ratio of total consumption to total income. Mathematically  $APC = \frac{C}{Y}$

Where, C= Consumption, Y= Income

**MPC** (Marginal Propensity to consume) is defined as the ratio of change in consumption to change in income. Mathematically  $MPC = \frac{\Delta C}{\Delta Y}$

Where,  $\Delta C$ =Change in consumption,  $\Delta Y$ =Change in income.

The value of MPC can never be greater than 1 because change in consumption can never be greater than change in income.

**78. Define linear consumption function.**

**Ans:** - If the consumption function is given on the basis of constant marginal propensity to consume, is called linear consumption.

$$C = \bar{C} + bY$$

Where, C = Consumption;  $\bar{C}$  = Autonomous consumption / minimum level of consumption; b = Marginal propensity to consume; Y= Level of income.

**79. Explain the meaning of equilibrium level of income with the help of a diagram.**

**Ans:** - The level of income and output in an economy is determined at that point where; aggregate demand is equal to aggregate supply.

$$AD = C + I$$

$$AS = C + S$$

$$AS = Y \text{ (refers to countries national income)}$$

At equilibrium point  $AD = AS$ .

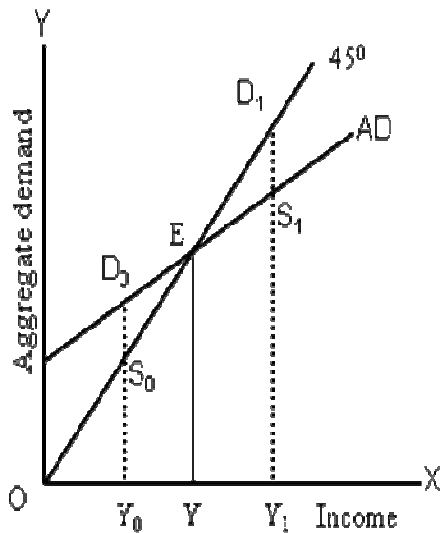
Equilibrium can be achieved at full employment and even at under employment situation. It may not be always at full employment condition in an economy.

We can explain it with the help of following schedule and diagram-

Income Y) (₹)	Consumption(C) (₹)	Investment (I) (₹)	AD=C+I (₹)	AS=Y (₹)	Remark
0	50	100	150	0	AD>AS
100	100	100	200	100	
200	150	100	250	200	
300	200	100	300	300	AD=AS
400	250	100	350	400	AD<AS
500	300	100	400	500	

The above schedule shows equilibrium level of income is ₹ 300 where  $AD=AS$   $300=300$ .

We can explain it with the help of diagram as follows-



In diagram OY is the equilibrium level of income because at E aggregate demand is equal to aggregate supply.

Before this equilibrium level of income and output, when income falls to  $OY_0$ , AD is  $D_0Y_0$  against AS is  $S_0Y_0$ . This  $AD > AS$  indicates planned spending  $>$  planned output then there will be more demand for goods and services so the firms will increase the output. Consequently, employment, output and income will be increased till the equilibrium level of income and output OY is reached where  $AD = AS$ .

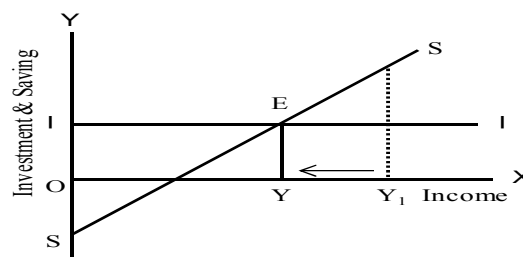
On the other hand, when  $AD < AS$  it means planned spending  $<$  planned output, then there will be unsold stock of goods with the firm so the firm will reduce the level of output to the equilibrium output. Consequently, output, income and employment will be reduced till the equilibrium level of income and output OY is reached where  $AD = AS$ .

**80. How equilibrium level of income and output is determined by the investment and saving in the economy. In an economy planned savings exceed planned investment. How will the equality between the two be achieved? Explain.**

**Ans:-** In an economy, equilibrium level of income and output will be determined at that point where investment is equal to saving.

At equilibrium  $I=S$

Excess of planned savings over planned investment means that the expenditure in the economy is less than what the producers had expected. This would result in undesired or unplanned build up of unsold stock. To correct this situation producer will produce less. This will reduce level of output and income. Fall in income will result in fall in savings. These changes will continue till income falls to a level at which savings equal investment.



**81.Explain how the multiplier is related with MPS and MPC.****Ans: - Relationship between multiplier and MPS**

Since,  $K = \frac{1}{MPS}$  so the value of multiplier varies inversely with the value of MPS. Higher the value of MPS, the smaller will be the value of multiplier and lower the value of MPS; the larger will be the value of multiplier.

**Relationship between multiplier and MPC**

Since,  $K = \frac{1}{1 - MPC}$  so the value of multiplier varies directly with the value of MPC. Higher the value of MPC, the larger will be the value of multiplier and lower the value of MPC, the smaller will be the value of multiplier.

**82.What do you mean by multiplier? Explain the working of investment multiplier with the help of a numerical example?**

**Ans :- Multiplier** is the ratio of change in income to change in investment.

$K = \frac{\Delta Y}{\Delta I}$  , Where  $\Delta Y$  is change in income and  $\Delta I$  is change in investment.

**Working of the multiplier** -The working of the multiplier is based on the fact that one person's expenditure is other person's income. When investment increases, it increases the income consequently consumption also increases. And increase in consumption lead to increase in income.

Symbolically:  $\Delta I \rightarrow \Delta Y \rightarrow \Delta C \rightarrow \Delta Y$

It can be explain with the help of an example as follows.

Suppose in an economy investment increases by ₹ 1,000 and MPC is 0.5 or 50%. How increase in investment affect income can be shown in the following table:

<b>Rounds</b>	<b>Increase in Investment (<math>\Delta I</math>) [₹]</b>	<b>Increase in Income (<math>\Delta Y</math>) [₹]</b>	<b>Increase in Consumption (<math>\Delta C</math>) [₹]</b>
i	1,000	1,000	500 (= 0.5×1,000)
ii	---	500	250 (= 0.5 × 500)
iii	---	250	125 (= 0.5×250)
iv	---	---	---
v	---	---	---
--	---	---	0
<b>Total</b>	<b>1,000</b>	<b>2,000</b>	<b>1,000</b>

In example ,the initial increase in investment is of ₹ 1,000 .The impact of this new investment of ₹ 1,000 will be that the income of employees working in the economy will increased by ₹ 1,000.The MPC is 0.5 or 50% so they will spend ₹ 500(50% ×1,000) on their new consumption goods. The producers of these goods will have an extra income of ₹ 500 and this will increase their

consumption expenditure by ₹ 250 ( $50\% \times 500$ ). This process continues till the effect of all is over or change in consumption is zero.

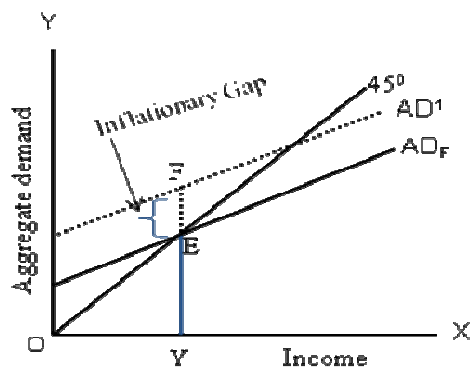
We can get it by calculation as follows-

$$\begin{aligned}\Delta Y &= \frac{1}{1 - MPC} \times \Delta I \\ \Delta Y &= \frac{1}{1 - 0.5} \times 1,000 \\ &= \frac{1}{0.5} \times 1,000 \\ &= 2 \times 1,000 \\ &= ₹ 2,000\end{aligned}$$

By calculation, we see that the increase in investment of ₹ 1,000 has increase the income by ₹ 2,000. Thus income is increasing twice of the increase in investment which shows value of multiplier is two.

### 83. Explain the meaning of inflationary gap with the help of diagram and also write measures to correct it.

**Ans: - Inflationary Gap-** The excess of actual aggregate demand over aggregate supply at full employment equilibrium point is called inflationary gap. When  $AD > AS$  this lead to price rise or inflation so it's called inflationary gap. We can show it with the help of diagram as follows.



In diagram EF shows inflationary gap.

**Impact on the Economy-** As aggregate demand is greater than aggregate supply; producers want to produce more output. But output cannot increase as there is non-availability of resources due to full employment.

**Income** - Real income cannot increase because real output can't increase only money income will increase.

**Price** - Price will increase. It will lead to an increase in monetary income.

#### Measures to correct inflationary gap-

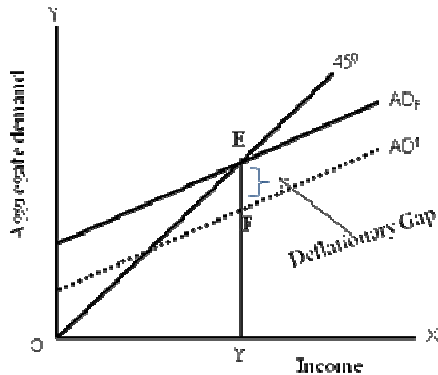
- Reduction in government expenditure -
- Increase in taxes
- Reduction in availability of credit - By increase in bank rate, increase in CRR&SLR, sale of securities by central bank, increase in margin requirement etc.



**84. Explain the meaning of deflationary gap (deficient demand) in an economy with the help of diagram and also write measures to correct it.**

**Ans:- Deflationary Gap-** The extent to which actual aggregate demand fall short to aggregate supply, at full employment equilibrium point is called deflationary gap.

When  $AD < AS$  this lead to fall in price regularly or deflation so it's called deflationary gap.



In diagram EF shows deflationary gap.

**Impacts on the Economy:** - As  $AD < AS$ , producers wish to produce less. The level of output and income will reduce.

**Impacts on output** - Output will reduce.

**Employment** - Level of employment will decrease.

**Price** - Price will fall

**Measures to correct deflationary gap-**

- Increase in government expenditure
- Decrease in taxes
- Increase in availability of credit - by decrease in bank rate, decrease in CRR & SLR, purchase of securities by central bank, decrease in margin requirement etc.

**85. Define a government budget, state any four of its main objectives.**

**Ans: - Government Budget** - It is an annual financial statement of estimated receipts and expenditure of the government for coming financial year.

**Objectives of a Government Budget -**

(i) **Reallocation of resources** - The Government has to reallocate resources from less priority areas to more priority areas, to achieve its social and economic objectives.

(ii) **Reduction of inequalities** - Through the budget government can adopt progressive taxation policy and spend more on requirement of the poor to reduce the inequalities of income and wealth.

(iii) **Economic growth**- To promote rapid and balanced economic growth so as to improve living standard of the people.

(iv) **Economic stability**- The Government tries to prevent business fluctuations and maintain economic stability to maintain price stability and correct business cycles.

(v) **Reduction of poverty and unemployment**- To eradicate (reduce) mass poverty and unemployment by creating employment opportunities and providing maximum social benefits to the poor.

(vi) **Management of public enterprises** - Government undertakes commercial activities that are of the nature of natural Monopolies, heavy manufacturing etc., through its public enterprises.

### **86. Define tax. What is direct and indirect taxes give some examples of each.**

**Ans: - Tax** – Tax is a legally compulsory payment imposed by the government.

**Direct tax**- A tax in which liability to pay tax and actual burden of the tax falls on the same person. The burden of these taxes cannot be shifted to other person. These taxes can be made progressive easily. Examples- income tax, corporation tax, wealth tax, gift tax etc.

**Indirect tax**- A tax in which liability to pay tax is of one person but actual burden of the tax falls on the some other person. The burden of these taxes can be shifted to some other person. These taxes cannot be made progressive easily. These can be made progressive by imposing more taxes on luxury items which are mainly used by the high income group people. Examples- sales tax, excise duty, service tax, VAT etc.

### **87. What do you mean by revenue receipts? Why is tax, profits of public sector undertakings, corporation tax, fee of Government College, grant and aid treated as revenue receipts?**

**Ans: - Revenue receipt** is a receipt which neither reduces an asset nor creates any liability.

**Tax** neither reduces assets nor creates a liability for the government. So treated as a revenue receipt.

**Corporation tax** neither reduces assets nor creates any liability for the government. So treated as a revenue receipt.

**Fee of Government College** neither reduces assets nor creates any liability for the government. So treated as a revenue receipt.

**Grant and aid** neither reduces assets nor creates any liability for the government. So treated as a revenue receipt.

**Profits of public sector undertakings** neither reduce assets nor create any liability for the government. So treated as a revenue receipt.

**88. What do you mean by capital receipts? Why are borrowings, recovery of loans and disinvestment treated as capital receipts?**

**Ans:** - **Capital receipt** is a receipt which either reduces an asset or creates any liability.

**Borrowings** treated as capital receipts because borrowings create a liability.

**Recovery of loans** treated as capital receipts because recovery of loans reduces an asset.

**Disinvestment** treated as capital receipts because disinvestment reduces an asset.

**89. What do you mean by revenue expenditure? Why is payment of interest and subsidies revenue expenditure?**

**Ans:** - **Revenue expenditure** is an expenditure which neither creates an asset nor reduces any liability.

**Payment of interest** neither creates an asset nor reduces any liability. So treated as revenue expenditure.

**Subsidies** neither create an asset nor reduce any liability. So treated as revenue expenditure.

**90. What do you mean by Capital expenditure? Why is repayment of loan, purchase of railway coach from Japan, construction of a bridge and purchase of share in a company a capital expenditure?**

**Ans:** - **Capital expenditure** is an expenditure which either creates an asset or reduces any liability

**Repayment of loan** reduces the liability of government. So treated as capital expenditure.

**Purchase of railway coach from Japan** creates an asset. So treated as capital expenditure.

**Construction of a bridge** creates an asset. So treated as capital expenditure.

**Purchase of share in a company** creates an asset. So treated as capital expenditure.

**91. What is the basis of classify government expenditure into revenue expenditure and capital expenditure? Give an example of each.**

**Ans:** - There are two basis of classifying the expenditure-

- i) Creation of an asset
- ii) Reduction of any liability.

Any expenditure that neither creates an asset nor reduces any liability is called revenue expenditure. Example- Payment of salaries, subsidies, interest payment etc.

Any expenditure that either creates an asset or reduces any liability is called **capital expenditure**. Example- Construction of factory, repayment of loan, purchase of share etc

**92. What are the various types of deficits in government budget? Also write their implications.**

**Ans:** - There are 3 types of deficits: -

**Revenue Deficit-** The excess of government revenue expenditure over revenue receipts is called revenue deficit.

$$\text{Revenue Deficit} = \text{Revenue Expenditure} - \text{Revenue Receipts}$$

**Implications**

- It implies dissavings of government.
- It indicates the inability of the government to meet its regular and recurring expenditure.
- A high revenue deficit gives a warning signal to the government to either curtail its expenditure or increase its revenue.
- Revenue deficit is financed through capital receipts like borrowings and used to meet the consumption expenditure of the government. It leads to inflationary pressure in the economy.

**Fiscal Deficit-** The excess of total expenditure of the government over its total receipts excluding borrowing is called fiscal deficit.

$$\text{Fiscal Deficit} = \text{Total Expenditure} - \text{Total Receipts excluding borrowing}$$

**Implications-**

- It indicates total borrowing requirements of the government. Borrowing create problem of not only payment of interest but also repayment of loans. If it continuously increases it means government takes more loans to repay the previous loans. As a result country is caught in debt trap.
- If government borrows from central bank, central bank issue new currency notes. It increases money supply and generates inflationary pressure in the economy.
- When government borrows from rest of the world, it raises the country's dependence on other countries.

**Primary Deficit-** the excess of fiscal deficit over interest payments is called primary deficit.

$$\text{Primary Deficit} = \text{Fiscal Deficit} - \text{Interest Payments}$$

**Implications:**

- It indicates how much of the government borrowing are going to meet expenses other than interest payments.
- If it is zero, it indicates that government is only borrowing to repay the interest of previous loans.

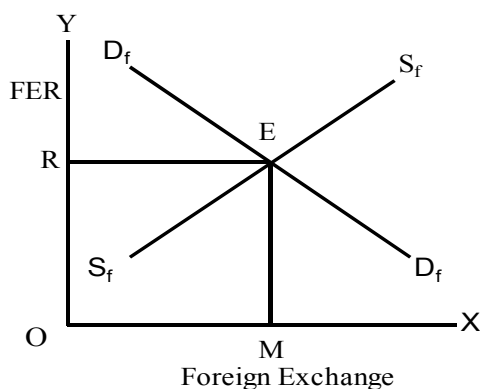
**93. What is meant by foreign exchange rate? How it can be determined? Explain.**

**Ans: - Foreign Exchange Rate** – It is a rate at which the currency of one country is exchanged with the currency of other country e.g., \$1 = ₹ 48 or one Indian rupee  $1/48^{\text{th}}$  \$.

**Determination of the FER** – The rate is determined in the foreign exchange market by the interaction of the demand for and supply of foreign exchange.

**Demand for Foreign exchange comes from** - Domestic residents purchase goods and services from other countries (imports), for sending gifts to foreigners, by the domestic residents to purchase financial assets in other country, speculative purpose and tourists going abroad etc. There is inverse relationship between foreign exchange rate and demand for foreign exchange. So demand curve for foreign exchange is downward sloping.

**Supply of Foreign exchange comes from** - The foreigner's purchasing goods and services (exports), the foreigners who invest in home country through joint ventures, remittances from abroad, foreign tourists come to visit a country. There is direct relationship between foreign exchange rate and supply of foreign exchange. So supply curve of foreign exchange is upward sloping.



In diagram,  $D_f D_f$  is demand and  $S_f S_f$  is supply curve of foreign exchange. They are equal at point E, so E is equilibrium point. At this point OR is determined as equilibrium foreign exchange rate.

**94. When exchange rate of foreign currency rise its supply rises? Explain.**

**Ans: -** A rise in foreign exchange rate makes home country's goods cheaper to foreigners so they will purchase more goods and services, as a result demand for country's goods increases in foreign market which leads to increase in country's exports. At the same time foreigners who want to invest in home country will

invest more, more foreign tourists will come to visit home country. This brings a greater supply of foreign exchange. Hence supply of foreign currency rises.

**95. What is meant by visible and invisible items in the Balance of payments account? Give some examples of each.**

**Ans: - Visible items** refer to items relating to trade of material goods with other countries.

Examples - tea, clothes, machinery etc.

**Invisible items** refer to items relating to trade of services with other countries and unilateral transfers.

Examples- Transport services, Insurance and banking services etc.

**96. Differentiate between fixed exchange rate and flexible exchange rate system.**

**Ans: -**

Sl. No.	Fixed Exchange Rate System	Flexible Exchange Rate System
i	The system in which exchange rate is officially declared by government or central bank of a country and only a very small deviation from this fixed value is possible is called <i>Fixed Exchange Rate System</i> .	The system in which exchange rates are determined by the demand and supply forces of foreign exchange in the market is called <i>Flexible Exchange Rate System</i> .
ii	<p><b><u>Advantages (Merits)</u></b></p> <p>1-It ensures stability, in the exchange rate which encourages international trade.</p> <p>2- It prevents speculations in foreign exchange market.</p> <p>3- It helps co-ordination of macroeconomics policies across different countries of the world.</p> <p>4- It implies low risk and low uncertainty of future payments so.</p>	<p><b><u>Advantages (Merits)</u></b></p> <p>1-This system does not require huge reserves of gold and international currencies.</p> <p>2-This system <b>does not</b> require the huge back-up of international reserves so encourage the movement of capital across different parts of the world.</p> <p>3-Deficit and surplus in BOP is automatically corrected.</p>
iii	<p><b><u>Disadvantages (Demerits)</u></b></p> <p>1-This system requires huge reserves of gold and international currencies.</p> <p>2-In this system the benefits of free markets are deprived.</p>	<p><b><u>Disadvantages (Merits)</u></b></p> <p>1-It encourages speculation leading to fluctuations in exchange rate.</p> <p>2- It discourages investment and international trade.</p>

**97. Differentiate between Balance of Trade and Balance of Payments.****Ans :- Difference Balance of Trade and Balance of Payments**

Sl. No.	Balance of Trade (BOT)	Balance of Payments (BOP)
i	Balance of trade is the difference between the money value of exports and imports of goods during a given period of time.	BOP is a systematic record of all the economic transactions of residents of a country with rest of world during a given period of time.
ii	It includes only visible items.	It includes both visible and invisible items.
iii	It's a narrow concept as it is a part of balance of payment.	It's a wider concept as it includes balance of trade in it.
iv	It can be favourable, un- favourable or balance.	It is always balanced.
v	It is not a true indicator of economic condition of a country.	It represents a better picture of a country's economic condition than the balance of trade.

**98. Differentiate between current account and capital account of BOP.****Ans:- Difference between current account and capital account of BOP-**

Sl. No.	Current Account	Capital Account
i	It is the account which records exports and imports of goods, services and unilateral transfers.	It records capital transactions such as loan and investment between a country and rest of the world.
ii	Items of current account do not cause change in the assets and liability status of the residents of a country & its government.	Items of capital account cause change in the assets and liability status of the residents of a country & its government.
iii	The main components of current account are export and import of goods, services and unilateral transfers.	The main components of capital account are private capital transaction, official capital transaction and banking capital transaction etc.

**99. What do you mean by deficit of balance of payment?**

**Ans: - Deficit in BOP-** If in current account of balance of payment (BOP), autonomous receipts are less than autonomous payments, then balance of payment (BOP) is said to be in deficit. It reflects disequilibrium in BOP.

**100. Differentiate b/w autonomous and accommodating items of BOP.**

**Ans:-**

Sl. No.	Autonomous items	Accommodating items
i	These refer to those international economic transactions that take place due to some economic motive such as profit maximisation.	These refer to those transactions that occur due to other activities of BOP.
ii	These items are independent of the state of BOP account.	These items are meant to maintain the balance in BOP account.
iii	These transactions occur in both <i>current account</i> and <i>capital account</i> .	These transactions occur only in <i>capital account</i> .
iv	These items are also called <i>above the line items</i> because they are recorded as first items before calculating surplus or deficit in BOP.	These items are also called <i>below the line items</i> because they are recorded after calculating surplus or deficit in BOP.

**With Best Wishes**

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