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1. Describe the five major sectors in an economy according to the macroeconomic point of view. [3-4 Marks]

Ans: An economy may be divided into different sectors depending on the nature of study.

1. Producer sector engaged in the production of goods and services.
2. Household sector engaged in the consumption of goods and services.
Note: Households are taken as the owners of factors of production.
3. The government sector engaged in activities like taxation and subsidies.
4. Rest of the world sector engaged in exports and imports.
5. Financial sector (or financial system) engaged in the activity of borrowing and lending.

2. What are the four factors of production and remunerations to each of these called? [1 Mark]

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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3. What are the important features of a capitalist economy? [3-4 Marks]

Ans: Features of capitalist economy are:

1. Private ownership of land and capital.
2. Profit is the only motive.
3. Free play of the market forces of demand and supply.
4. Government looks after growth, stability and social justice in the economy.

4. Describe the Great Depression of 1929. [3-4 Marks]

Ans: The Great Depression took place in 1929 which adversely affected the developed

economies of Europe and North America. It continued for 10 years. There was extreme fall in aggregate demand due to fall in income, which led to a vicious circle of poverty.

5. Distinguish between stock and flow. Between net investment and capital which is a stock and which is a flow? Compare net investment and capital with flow of water into a tank. [3-4 Marks]

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Net investment is a flow whereas capital is a stock. Amount of water in a tank at a particular point of time is a stock concept, whereas amount of water flowing into it is a flow concept.

MORE QUESTIONS SOLVED

I. VERY SHORT ANSWER TYPE QUESTIONS (1 Mark)

1. What is meant by circular flow of income?

Ans: It refers to flow of money income or the flow of goods and services across different sectors of the economy in a circular form.

2. What are the three phases of circular flow of income?

Ans: Production Phase, Distribution Phase and Disposition Phase.

Question 3. Give the meaning of factor income.

Ans: Income earned by factor of production by rendering their productive services in the production process is known as Factor Income.

4. What is meant by transfer income?

Ans: Income received without rendering any productive services is known as Transfer Income.

5. Out of factor income and transfer income which one is a unilateral concept?

Ans: Transfer income.

6. Define current transfers.[CBSE 2003]

Ans: Transfers made from the current income of the payer and added to the current

income of the recipient (who receive) for consumption expenditure are called current transfers.

7. Define capital transfers.

Ans: Capital transfers are defined as transfers in cash and in kind for the purpose of investment to recipient made out of the wealth or saving of a donor.

8. What is the meaning of final goods?

Ans: These are those which are used for:

1. Personal consumption (like bread purchased by consumer household), or
2. Investment or capital formation (like building, machinery purchased by a firm)

9. What is meant by intermediate goods?

Ans: These are those, which are used for:

1. Further processing (like sugar used for making sweets), or
2. Resale in the same year (If car purchased by a car dealer for resale).

10. What is meant by consumption goods?

Ans: Consumption goods are those goods which satisfy the wants of consumers directly.

11. Define capital goods.

Ans: Capital goods are defined as all goods produced for use in future productive processes.

12. Give an example of a person who is staying abroad for a period more than one year and still he is treated as normal resident of India.

Ans: An Indian working in Indian Embassy in the USA will be treated as normal resident of India.

II. MULTIPLE CHOICE QUESTIONS (1 Mark)

1. Transfer payments refer to payments which are made:

- (a) Without any exchange of goods and services.
- (b) To workers on transfer from one job to another.
- (c) As compensation to employees.
- (d) None of these

Ans: (a)

2. Which one of the following items comes under consumption goods?

- (a) Durable goods
- (b) Semi-durable goods
- (c) Non-durable goods
- (d) All of these.

Ans: (d)

3. Service of a teacher:

- (a) Capital goods
- (b) Consumption goods
- (c) Intermediate goods
- (d) Can be Consumption goods and intermediate goods

Ans: (d)

4. In a circular flow of income, we have:

- (a) Production (b) Distribution
- (c) Disposition (d) All of them

Ans: (d)

5. Who is considered as agents of factor of production,

- (a) Households
- (b) Government
- (c) Rest of the world
- (d) All of these

Ans: (a)

6. Which among the following are the features of capitalist economy,

- (a) Private ownership of Land and Capital.
- (b) Profit is the only motive.
- (c) Free Play of market forces of demand and supply.
- (d) All of these

Ans: (d)

7. Flow of Goods & services and factors of production across different sectors in a barter economy is known as: [CBSE Sample Paper 2016]

- (a) Circular flow (b) Real flow
- (c) Monetary Flow (d) Capital Flow

Ans: (b)

III. SHORT ANSWER-TYPE QUESTIONS

1. Explain the basis of classifying goods into intermediate and final goods.

Give suitable examples. Or [CBSE 2010]

Distinguish between intermediate products and final products. Give examples. ' [CBSE 2009]

Ans:

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Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

2. Define consumption goods and what are its categories.

Ans: Consumption goods are those which satisfy the wants of the consumers directly. For example, cars, television sets, bread, furniture, air-conditioners, etc. Consumption goods can further be subdivided into the following categories:

- Durable goods:** These goods have an expected life time of several years and of relatively high value. They are motor cars, refrigerators, television sets, washing machines, air-conditioners, kitchen equipments, computers, communication equipments etc.
 - Semi-durable goods:** These goods have an expected life time of use of one year or slightly more. They are not of relatively great value. Examples are clothing, furniture, electrical appliances like fans, electric irons, hot plates and crockery.
 - Non-durable goods:** Goods which cannot be used again and again, i.e., they lose their identity in a single act of consumption are known as non durable goods. These are food grains, milk and milk products, edible oils, beverages, vegetables, tobacco and other food articles.
- goods which satisfy the human wants directly. They cannot be seen or touched, i.e., they are intangible in nature. These are medical care, transport and communications, education, domestic services rendered by hired servants, etc.

3. Define capital goods and its categories.

Or

Define 'capital goods'. [CBSE Foreign 2011]

Ans:

- Capital goods are defined as all goods produced for use in future productive processes.

2. For example, All the durable goods like cars, trucks, refrigerators, buildings, air crafts, air-fields and submarines used to produce goods and services for sale in the market are a part of capital goods.
3. Stocks of raw materials, semi finished and finished goods lying with the producers at the end of an accounting year are also a part of capital goods.
4. Some more examples of capital goods are machinery, equipment, roads and bridges.
5. These goods require repair or replacement over time as their value depreciate over a period of time.

4. Distinguish between consumption goods and capital goods. Which of these are final goods? [CBSE Delhi 2010]

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

5. Differentiate between Current transfers and Capital Transfers.

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

IV. GIVE REASONS

A. Giving reasons, classify the following into intermediate or final goods.

1. Machines purchased by a dealer of machines. [CBSE (AZ) 2010]

Ans: Intermediate good

Reason: Machines purchased by a dealer of machines is an intermediate good because machines are resold by the firms to make profits or value is yet to be added to these goods by way of further processing.

2. A car purchased by a household.[CBSE (AI) 2010]

Ans: Final good

Reason: A car purchased by a household is a final good because the household is the final user of the car and no value is to be added to the car.

3. Furniture purchased by a school. [CBSE Delhi 2011]

Ans: Final good

Reason: Furniture purchased by a school is a final product because school is the final user of the furniture and no value is to be added to the furniture. This will be deemed as investment expenditure because furniture is used by the school for several years and is of high value.

4. Chalks, dusters, etc. purchased by a school. [CBSE Delhi 2011]

Ans: Intermediate good

Reason: Chalks, dusters, etc. purchased by a school are intermediate goods as these are used up in the process of value – addition during the year.

5. Computers installed in an office.[CBSE Delhi 2011]

Ans: Final good

Reason: Computers installed in an office is a final product because computers are finally and repeatedly used by the office for several years and these are of high value.

6. Mobile sets purchased by a mobile dealer. [CBSE Delhi 2011]

Ans: Intermediate product

Reason: Mobile sets purchased by a mobile dealer is an intermediate product because these are purchased for resale.

7. Expenditure on maintenance of an office building. [CBSE Delhi 2011]

Ans: Intermediate product

Reason: Expenditure on maintenance of an office building is an intermediate expenditure as the things purchased for repair and maintenance are used up during the period of one year.

8. Expenditure on improvement of a machine in a factory.[CBSE Delhi 2011]

Ans: Final Product

Reason: Expenditure on improvement of a machine in a factory is a final expenditure as the machine is repeatedly used for several years as a fixed asset. Improvement of a machine implies improvement of asset value (through investment expenditure).

9. Purchase of furniture by a firm.[CBSE (AI) 2010]

Ans: Final Product

Reason: Purchase of furniture by a firm is a final expenditure because furniture is repeatedly used by the firm for several years and this is of high value.

10. Expenditure on maintenance by a firm. [CBSE (AI) 2010]

Ans: Intermediate product

Reason: Expenditure on maintenance by a firm is an intermediate expenditure as the things purchased for repair and maintenance are used up during the period of one year.

11. Paper purchased by a publisher.

Ans: Intermediate product

Reason: It is an intermediate product as paper is used for further production during the same year.

12. Milk purchased by households.

Ans: Final product

Reason: It is a final product as it is used by households for final consumption.

13. Purchase of rice by a grocery shop.

Ans: Intermediate product

Reason: These are intermediate products because these are purchased for resale.

14. Coal used by manufacturing firms.

Ans: Intermediate product

Reason: It is an intermediate product as coal is used for further production during the same year.

15. Coal used by consumer households.

Ans: Final product

Reason: It is a final product as it is used by households for final consumption.

16. Purchase of pulses by a consumer.

Ans: Final Product

Reason: It is a final product as it is used by a consumer for final consumption.

17. Fertilizers used by the farmers.

Ans: Intermediate product

Reason: These are intermediate products because fertilizer is used for further production during the same year.

18. Printer purchased by a lawyer.

Ans: Final product

Reason: It is a final product because it is purchased for investment.

19. Wheat used by the flour mill.

Ans: Intermediate product

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Reason: It is an intermediate product as wheat is used for further production during the same year or is meant for resale.

20. Unsold coal with trader at a year end.

Ans: Final product

Reason: It is a final product as the unsold coal is an investment for the trader.

21. Cotton used by a cloth mill.

Ans: Intermediate product

Reason: It is an intermediate product as cotton is used for further production during the same year.

22. Wheat used by households.

Ans: Final product

Reason: It is a final product as it is used by households for final consumption.

23. Refrigerator installed by a firm.

Ans: Final product

Reason: It is a final product because it is purchased for investment.

24. Sugar used by a sweet shop.

Ans: Intermediate product

Reason: It is an intermediate product as sugar is used for further production during the same year.

B. Giving reasons, classify the following into factor income or transfer income.

1. Unemployment allowances.

Ans: Transfer income

Reason: It is received without rendering any productive services.

2. Salary received by Pankaj from a company.

Ans: Factor income

Reason: It is earned by rendering productive services.

3. Financial help to earthquake victims.

Ans: Transfer income

Reason: It is received without rendering any productive services.

4. Compensation received from the employer.

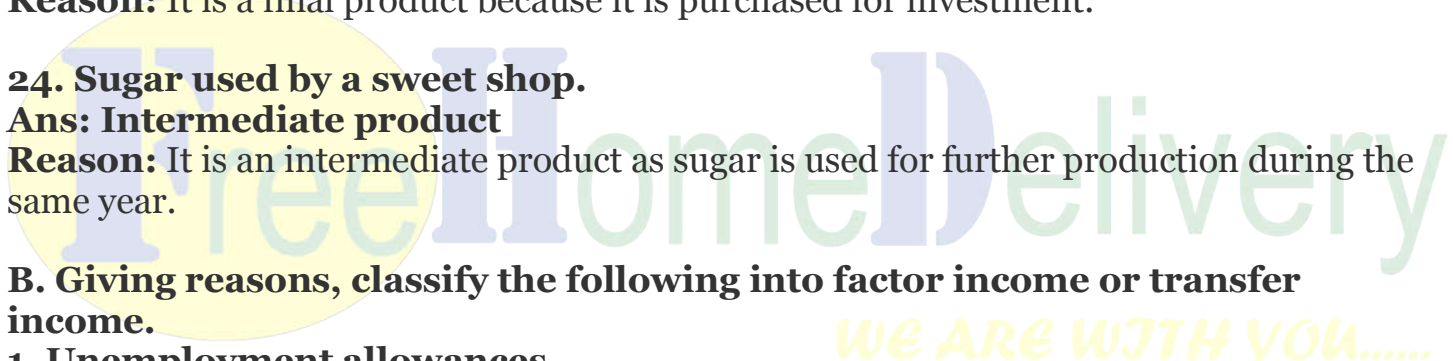
Ans: Factor income

Reason: It is earned by rendering productive services.

5. Claim received from Insurance company by an injured worker.

Ans: Transfer income

Reason: It is received without rendering any productive services.



6. Birthday gift received from a friend.

Ans: Transfer income

Reason: It is received without rendering any productive services.

7. Bonus received on Diwali.

Ans: Factor income

Reason: It is earned by rendering productive services.

C. Giving reasons, classify the following into stock or flow.

1. Capital [GBSE 2013]

Ans: Stock concept

Reason: Capital is stock because it is measured at a point of time.

2. Saving [CBSE 2013]

Ans: Flow concept

Reason: Saving is flow because it is measured during a period of time.

3. Gross Domestic Product [CBSE 2013]

Ans: Flow concept

Reason: Gross domestic product is a flow because it is measured during a period of time.

4. Wealth [CBSE 2013]

Ans: Stock concept

Reason: Wealth is stock because it is measured at a point of time.

5. Exports

Ans: Flow concept

Reason: It relates to a period of time.

6. Imports

Ans: Flow concept

Reason: It relates to a period of time.

7. Business capital of business

Ans: Stock concept

Reason: It is related to a point of time.

8. Investment

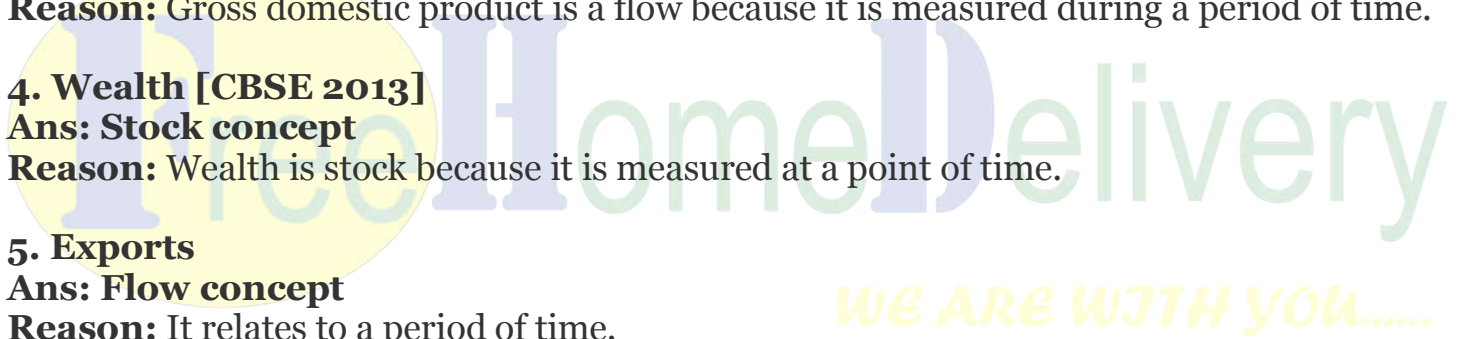
Ans: Flow concept

Reason: It relates to a period of time.

9. Foreign Investment

Ans: Flow concept

Reason: It relates to a period of time.



10. Foreign Assets

Ans: Stock concept

Reason: It relates to a point of time.

11. Foreign Remittances (In flow of money)

Ans: Flow concept

Reason: It is related to a period of time.

12. Production of Wheat

Ans: Flow concept

Reason: It is related to a period of time.

13. Income of a servant

Ans: Flow concept

Reason: It is related to a period of one month or one year.

14. Budget Expenditure

Ans: Flow concept

Reason: It is related to a period of time. (1 year)

15. Money supply

Ans: Stock concept

Reason: It relates to a particular point of time.

16. Machinery of a firm

Ans: Stock concept

Reason: It relates to a point of time.

17. A five hundred rupee note

Ans: Stock concept

Reason: It is related to a point of time.

D. Giving reasons state whether the following are included or excluded in/from domestic territory.

1. An Indian Company in America

Ans: Excluded

Reason: As it is outside the domestic territory of our country.

2. Microsoft Office in India

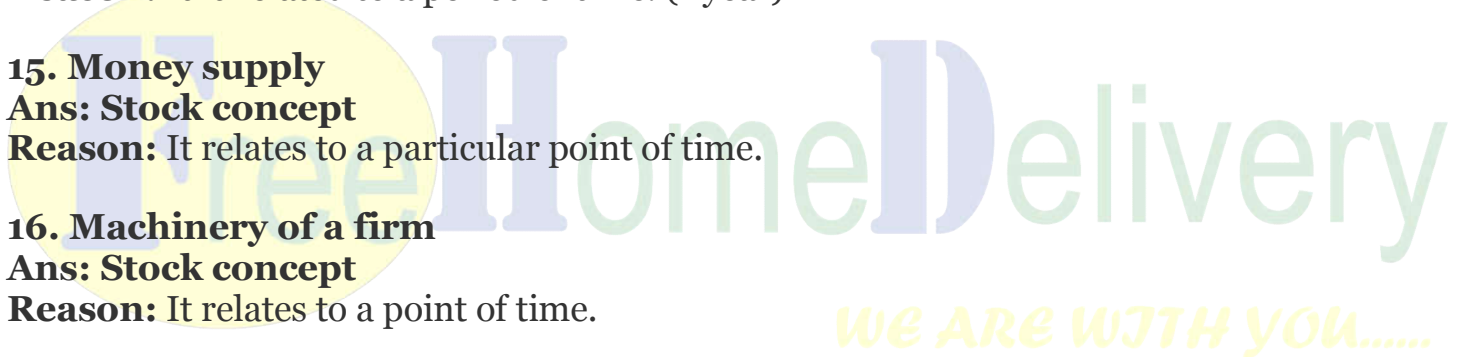
Ans: Included

Reason: As it is within the domestic territory of our country.

3. Company in India owned by an American

Ans: Included

Reason: As it is within the domestic territory of our country.



4. Office of Tata in New York

Ans: Excluded

Reason: As it is outside the domestic territory of our country.

5. Branch of Foreign Bank in India

Ans: Included

Reason: As it is within the domestic territory of our country.

6. Indian Embassy in China

Ans: Included

Reason: As it is within the domestic territory of our country.

7. Branch of Punjab National Bank in America

Ans: Excluded

Reason: As it is outside the domestic territory of our country.

8. Russian Embassy in India

Ans: Excluded

Reason: As it is outside the domestic territory of our country.

9. Reliance Industries rented its building to Microsoft in America.

Ans: Excluded

Reason: As it is outside the domestic territory of our country.

E. Classify the following into durable, non-durable, semi-durable or services

1. Refrigerator

Ans: Durable

Reason: As it has expected life time of several years and of relatively high value.

2. Clothes

Ans: Semi-durable

Reason: As it have an expected life time of use of one year or slightly more.

3. Edible oil

Ans: Non-durable

Reason: As it loose their identity in a single act of consumption.

4. Tuition given by a teacher

Ans: Service

Reason: As it is non-material goods which satisfy the human wants directly.

5. Visit of a physician

Ans: Service

Reason: As it is non-material goods which satisfy the human wants directly.

6. Washing soaps

Ans: Non-durable

Reason: As it loses their identity in a single act of consumption.

F. Classify the following into consumer, intermediate or capital goods.

1. Milk used by a manufacturer of sweets.

Ans: Intermediate goods

Reason: As it is used up while making sweets.

2. Cycle purchased by a consumer household

Ans: Consumer goods

Reason: End user is consumer.

3. Textile machinery

Ans: Capital goods

Reason: End user is producer.

4. Construction of a house

Ans: Consumer goods

Reason: End user is consumer.

5. Bread and butter used by a consumer household.

Ans: Consumer goods

Reason: End user is consumer.

6. Services of a private doctor purchased by a consumer household.

Ans: Consumer goods

Reason: End user is consumer.

7. Fertilizer used by a farmer.

Ans: Intermediate goods

Reason: As fertilizer is used for further production during the same year.

8. Passenger bus service used by a consumer household.

Ans: Consumer services

Reason: End user is consumer.

G. Giving reasons, classify the following into normal resident of India or not.

1. Indian officials working in the Indian Embassy in USA.

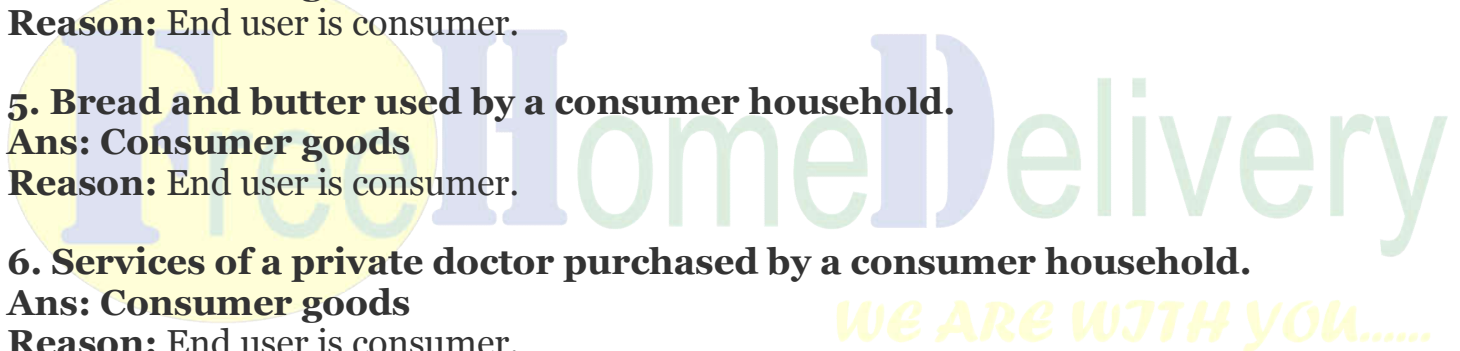
Ans: Normal Resident

Reason: As their centre of economic interest lies in the home country.

2. A Japanese tourist who stays in India for 2 months.

Ans: Not a Normal Resident

Reason: As their centre of economic interest lies in the foreign country.



3. Indians going to Pakistan for watching the cricket match.

Ans: Normal Resident

Reason: As their centre of economic interest lies in the home country.

4. Indians working in the UNO office, located in America for less than 1 year.

Ans: Normal Resident

Reason: As their centre of economic interest lies in the home country.

5. Indian employees working in WHO, located in India.

Ans: Normal Resident

Reason: As their centre of economic interest lies in the home country.

6. Foreign tourists visiting India for a month to see the Taj Mahal.

Ans: Not a Normal Resident

Reason: As their centre of economic interest lies in the foreign country.

V. TRUE OR FALSE

Giving reasons, state whether the following statements are true or false.

1. Macroeconomics deals with the problems of a consumer.

Ans: False: It deals with problems of the economy.

2. Money flow is also known as physical flow.

Ans: False: Real flow is known as physical flow. Money flow is known by the name of nominal flow.

3. In a two-sector economy, total production is always equal to total consumption.

Ans: True: It happens because firms sell their entire output to the households.

4. Circular flow of income takes place in case of open economy and close economy.

Ans: True: Even in case of closed economy, circular flow of income takes place between households and firms.

5. Capital formation is a flow.[CBSE Sample Paper 2010]

Ans: True: Capital formation is measured over a period of time

6. Foreign remittances are a stock concept.

Ans: False: It is flow concept as these are assessed over a period of time and not at a point of time.

7. National Income of a country- is a stock concept.

Ans: False: It is a flow concept as it is measured over a period of time.

8. Bread is always a consumer good.[CBSE Sample Paper 2010]

Ans: False: It depends on the use of bread. When it is purchased by a household, it is a consumer good. If it is purchased by a restaurant, it is a producer intermediate goods.

9. Television is a capital good.

Ans: False: Television is a durable consumption good.

10. Services of a teacher is a consumption good.

Ans: True: It directly satisfies human wants.

11. Books in a library are intermediate goods.

Ans: False: Books used in a library are final goods as these are used by the end user.

12. Use of raw material is a consumption good.

Ans: False: Use of raw material helps in production process therefore it is a single use producer good. But it has no longer life.

13. Can purchase of a new car be categorized as an intermediate good.

Ans: True: Purchase of a new car can be categorized as an intermediate good, if purchased by a Government for military use or if it is purchased by a car dealer for resale.

14. A good can be an intermediate goods in one case and a final goods in another case.

Ans: True: A good can be an intermediate goods or final goods, depending upon its nature of use. For example, a car purchased by a household is a final good, whereas, it will be an intermediate good if it is purchased by a car dealer.

15. The concept of normal resident applies to individuals only.

Ans: False: The concept applies to institutions also, in addition to individuals.

16. In final goods, no value is to be added.

Ans: True: Because final goods have crossed the production boundary.

17. Transfer income is a part of factor income.

Ans: False: It is not a factor income, It is paid for without receiving any goods and services.

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VI. HIGHER ORDER THINKING SKILLS

1. Explain that Domestic territory is bigger than the political frontiers of a country.

Ans: In layman terms, the domestic territory of a nation is understood to be the territory

lying within the political frontiers (or boundaries) of a country. But in national income accounting, the term domestic territory is used in a wider sense. Based on 'freedom' criterion, the scope of economic territory is defined to cover:

1. Ships and air crafts owned and operated by normal residents between two or more countries. For example, Indian Ships moving between China and India regularly are part of domestic territory of India. Similarly, planes operated by Air India between Russia and Japan are part of the domestic territory of India. Similarly, planes operated by Malaysian Airlines between India and Japan are a part of the domestic territory of Malaysia.
2. Fishing vessels, oil and natural gas rigs and floating platforms operated by the residents of a country in the international waters where they have exclusive rights of operation. For example, Fishing boats operated by Indian fishermen in international waters of Indian Ocean will be considered a part of domestic territory of India.
3. Embassies, consulates and military establishments of a country located abroad. For example, Indian Embassy in Russia is a part of the domestic territory of India. 'Consulate' is an office or building used by consul (an officer commissioned by the government to reside in a foreign country to promote the interest of the country to which he belongs).

2. "All Producer Goods are not Capital Goods". Explain.

Ans: Producer goods are all those goods which are used in the process of production i.e., which are used in the production of other goods. Producer goods include two types of goods:

1. **Single-use Producer Goods:** Goods used as raw material by the producers. It includes raw material like coal, wood, etc. They are not capital goods as they cannot be repeatedly used in the production process.
2. **Capital Goods:** Goods which are used as fixed assets by the producers, like plant and machinery, which can be repeatedly used in the production process. So, it can be said that all capital goods are producer goods, but all producer goods are not capital goods.

3. "Machine purchased is always a final good." Do you agree? Give reasons for your answer.

Ans: No, it is not necessary that machine purchased is a final good. It will depend upon its use.

1. If a machine is purchased by a household, then it is a final good. For example, washing machine purchased by a consumer household is a final goods.
2. If it is purchased by a firm for its own use, then it is also a final good. For example, refrigerator purchased by a firm.
3. If it is bought by a firm for resale, then it is an intermediate good. For example, machine purchased by a machine dealer.

4. “ Machine purchased is always a capital good.” Do you agree? Give reasons for your answer.

Ans: No, it is not necessary that machine purchased is a capital good. It will depend upon its use.

1. If a sewing machine is purchased by a tailor, then it is a fixed asset of the tailor and considered to be a capital good. But the same machine purchased by a consumer household is considered to be a durable use consumer goods.
2. If a car purchased by a taxi driver as a taxi or if purchased by a firm for use in its business is a capital good. But the same car purchased by a consumer household is a durable use consumer goods.

Note: So, finally, the end user of a good determine, whether it is capital good or durable use consumer goods. If an end user of a durable goods is a producer, it is a capital good. If an end user of a durable goods is a consumer household, it is a durable use consumer goods. So, capital goods are only those durable goods which are used as producer goods, not as consumer goods.

VII. VALUE BASED QUESTION

1. Compensation to flood victims is a good social security measure by the government. But why is it not included in the estimation of national income?

Ans: Because this is a transfer payment. Value: Implement of Knowledge

VIII. APPLICATION BASED QUESTIONS

1. The concept of domestic territory helps to estimate ‘Domestic Product’. Defend or refute.

Ans: The concept of domestic territory helps to estimate ‘Domestic Product’. As we know Domestic Product includes goods and services produced by production units located in the domestic territory (irrespective of fact whether carried out by residents or non-residents). The money value of domestic product is termed as Domestic Income.

2. The concept of Normal Resident helps to estimate ‘National Product’. Defend or refute.

Ans: The concept of Normal Resident helps to estimate “National Product’. National Product includes production activities of normal residents irrespective of fact whether performed within the economic territory or outside it. The money value of national product is termed as National Income.

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1. Why should the aggregate final expenditure of an economy be equal to the aggregate factor payments? Explain. [3 Marks]

Ans: The sum of final expenditures in an economy must be equal to the income received by all the factors of production taken together (final spending on final goods, it does not include spending on intermediate goods). This follows from the simple idea that the revenues earned by all the firms put together must be distributed among the factors of production as salaries, wages, profits, interests earning and rents.

2. What is the difference between planned and unplanned inventory accumulation? Write down the relation between change in inventories and value added of a firm. [3 Marks]

Ans: Planned Inventory. It refers to changes in the stock inventories that have occurred in a planned way. In a situation of planned inventory accumulation, firm will plan to raise its inventories.

Unplanned Inventory. It refers to changes in the stock of inventories that have occurred in an unexpected way. In a situation of unplanned inventory accumulation, due to unexpected fall in sales, the firm will have unsold stock of goods.

Value added of a firm (GVA) = Gross value of output produced by the firm – Value of intermediate goods used by the firm.

OR

GVA = Value of sales by the firm + Value of change in inventories – Value of intermediate goods used by the firm

3. Write down the three identities of calculating the GDP of a country by the three methods. Also, briefly explain why each of these should give us the same value of GDP. [3 Marks]

Ans: National Income = National Product = National Expenditure. Each one will give the same result. The only difference is that with product methods, NI is calculated at production or creation level with income Method NI is measured at distribution level, and with expenditure method NI is measured at disposal level.

4. Define budget deficit and trade deficit. The excess of private investment over saving of a country in a particular year was Rs 2,000 crores. The amount of budget deficit was (-) Rs 1,500 crores. What was the volume of trade deficit of that country? [3-4 Marks]

Ans: Budget deficit. It measures the amount by which the government expenditure exceeds the tax

revenue earned by it. Budget Deficit = $G - T$.

Trade deficit: It measures the amount of excess expenditure over the export revenue earned by the country.

Trade Deficit = $M - X$

Given $G - T = (-)$ Rs 1500 crore

Investment - Saving = Rs 2000 crore Trade deficit = $[I - S] + [G - T]$
 $= [2000] + [-1500] = \text{Rs } 500 \text{ crore.}$

5. Suppose the GDP at market price of a country in a particular year was Rs 1,100 crores. Net Factor Income from Abroad was Rs 100 crores. The value of Indirect taxes - Subsidies was Rs 150 crores and National Income was Rs 850 crores. Calculate the aggregate value of depreciation. [3 Marks]

Ans: National Income (or NNPF) = $\text{GDPmp} - \text{Depreciation} + \text{Net factor income from abroad} - [\text{Indirect Taxes} - \text{Subsidies}]$
 $850 = 1100 - \text{Depreciation} + 100 - 150$
 $\text{Depreciation} = 1100 + 100 - 150 - 850$ Depreciation = Rs 200 Crore

6. Net National Product at Factor Cost of a particular country in a year is Rs 1,900 crores. There are no interest payments made by the households to the firms / government, or by the firms / government to the households. The Personal Disposable Income of the households is Rs 1,200 crores. The personal income taxes paid by them is Rs 600 crores and the value of retained earnings of the firms and government is valued at Rs 200 crores. What is the value of transfer payments made by the government and firms to the households? [3-4 Marks]

Ans: Personal disposable income = Personal income - Personal tax - miscellaneous receipts of government
 $1200 = \text{Personal Income} - 600 - 0$ Personal Income = 1800 Crore
Private Income = Personal income + retained earnings + corporate tax = $1800 + 200 + 0 = 2000$ Crore
Private income = NNPF (National income) - NDPFC of government sector + Value of transfer payment
 $2000 = 1900 - 0 + \text{Value of transfer payment}$
Value of transfer payment = 100 Crore

7. From the following data, calculate Personal Income and Personal Disposable Income. [6 Marks]

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Ans: Private Income = NDPFC - NDPFC of government sector + NFIA + Transfer Income + net interest receive from household (Interest Received by Households - Interest Paid by Households) =
 $(i) - 0 + (ii) + (vii) + [(v) - (vi)]$
 $= 8000 + 200 + 300 + (1500 - 1200)$
 $= 8800$ Crore

Personal Income = Private income - Undistributed profit - Corporation tax = $8800 - (iii) - (ii)$

= 8800 – 1000 – 500 = 7300 Crore
Personal Disposable Income =
Personal income – Personal tax = 7300 – (viii)
= 7300 – 500 = 6800 Crore

8. In a single day Raju, the barber, collects Rs 500 from haircuts; over this day, his equipment depreciates in value by Rs 50. Of the remaining Rs 450, Raju pays sales tax worth Rs 30, takes home Rs 200 and retains Rs 220 for improvement and buying of new equipment. He further pays Rs 20 as income tax from his income. Based on this information, complete Raju's contribution to the following measures of income

1. **Gross Domestic Product**
2. **NNP at market price**
3. **NNP at factor cost**
4. **Personal income**
5. **Personal disposable income. [3-4 Marks]**

Ans:

1. GDP contribution by Raju = Rs 500
2. NNPMP (Raju's contribution) = GDP – Depreciation = 500 – 50 = Rs 450.
3. NNPr (Raju's contribution) = NNPMP - Indirect tax = 450 - 30 = Rs 420
4. Personal Income = NNPF - Retained Earnings = 420 – 220 = Rs 200
5. Personal Disposable Income = Personal Income – Income Tax = 200 – 20 = Rs 180 Crore

9. The value of the nominal GNP of an economy was Rs 2,500 crores in a particular year. The value of GNP of that country during the same year evaluated at the prices of the same base year was Rs 3,000 crores. Calculate the value of the GNP deflator of the year in percentage terms. Did the price level rise between the base year and the year under consideration? [3-4 Marks]

Ans: GNP deflator = Nominal GNP/Real GNP x 100 = 83.3%

No, the price level did not rise between the base year and the year under consideration. In fact, it fell.

10. Write down some of the limitations of using GDP as an index of welfare of a country. [6 Marks]

OR

Explain how distribution of gross domestic product is its limitation as a measure of economic welfare.

[CBSE Delhi 2010]

OR

Explain how 'distribution of gross domestic product' is a limitation in taking domestic product as an index of welfare. [CBSE Delhi 2011]

OR

Can gross domestic product be used as an index of welfare of the people? Give two reasons. [CBSE Foreign 2010]

OR

Explain Per Capita Real GDP as Indicator of Economic Welfare.

OR

Explain any four limitations of using GDP as a measure/index of welfare of a country. [CBSE Sample Paper 2016]

Ans: Per Capita Real GDP can be taken as indicator for economy. But by itself is not an adequate indicator. There are many reasons behind this. These are:

1. Many goods and services contributing economic welfare are not included in GDP Or Non-Monetary exchanges.
 - (a) There are many goods and services which are left out of estimation of national income on account of practical estimation difficulties e.g., services of housewives and other members, own account production, etc.
 - (b) These are left on account of non availability of data and problem in valuation.
 - (c) It is generally agreed that these items contribute to economic welfare.
 - (d) So, if we depend only on GDP, we would be underestimating economic welfare.
2. Though externalities are not taken into account in GDP, they affect welfare.
 - (a) When the activities of somebody result in benefits or harms to others with no payment received for the benefit and no payment made for the harm done, such benefits and harms are called externalities.
 - (b) Activities resulting in benefits to others are positive externalities and increase welfare; and those resulting in harm to others are called negative externalities, and thus decrease welfare.
 - (c) GDP does not take into account these externalities.
 - (d) For example, construction of a flyover or a highway reduces transport cost and journey time of its users who have not contributed anything towards its cost. Expenditure on construction is included in GDP but not the positive externalities flowing from it. GDP and positive externalities both increase welfare. Therefore, taking only GDP as an index of welfare understates welfare. It means that welfare is much more than it is indicated by GDP.
 - (e) Similarly, GDP also does not take into account negative externalities. For examples, factories produce goods but at the same time create pollution of water and air. River Yamuna, now a drain, is a living example. The pollution harms people. The factories are not required to pay anything for harming people. Producing goods increases welfare but creating pollution reduces welfare. Therefore, taking only GDP as an index of welfare overstates welfare. In this case, welfare is much less than indicated by GDP.
3. Change in the distribution of income (GDP) may affect welfare.
 - (a) All people do not earn the same amount of income. Some earn more and some earn less. In other words, there is unequal distribution of income.
 - (b) At the same time, it is also true that in the event of rise in 'per capita real income' all are not better off equally. 'Per capita' is only an average. Income of some may rise by less and of some by more than the national average. In case of some it may even fall.
 - (c) It means that the inequality in the distribution of income may increase or decrease.
 - (d) If it increase it implies that rich become more rich and the poor become more poor.
 - (e) Utility of a rupee of income to the poor is more than to the rich. Suppose, the income of the poor declines by one rupee and that of the rich increases by one rupee. In such a case, the decline in welfare of the poor will be more than the increase in welfare of the rich.
 - (f) Therefore, if the rise in per capita real income inequality increases, it may lead to a decline in welfare (in the macro sense).
4. All products may not contribute equally to economic welfare.
 - (a) GDP includes different types of products, like food articles, houses, clothes, police services, military services, etc.
 - (b) Some of these products contribute more to the welfare of the people, like food, clothes, houses, etc. Other products like police services, military services etc. may comparatively contribute less and may not directly affect the standard of living of the people.
 - (c) Therefore, how much is the economic welfare would depend more on. the types of goods and

services produced, and not simply how much is produced.

(d) It means that if GDP rises, the increase in welfare may not be in the same proportion.

5. Contribution of some products may be negative

(a) GDP includes all final products whether it is milk or liquor.

(b) Milk may provide both immediate and ultimate satisfaction to consumers. On the other hand, liquor may provide some immediate satisfaction, but because of its harmful effects on health it may lead to decline in welfare.

(c) GDP include only the monetary values of the products and not their contribution to welfare.

(d) Therefore, economic welfare depends not only on the volume of consumption but also on the type or goods and services consumed.

MORE QUESTIONS SOLVED

I. VERY SHORT ANSWER TYPE QUESTIONS (1 Mark)

1. Define 'depreciation'. [CBSE (AI) 2011]

Ans: Depreciation is an expected decrease in the value of fixed capital assets due to its general use.

2. When is the net domestic product at market price less than the net domestic product at factor cost?

Ans: When net indirect taxes are negative i.e., subsidies are more than indirect taxes.

3. Why is gross domestic product at factor cost more than the net domestic product at factor cost?

Ans: Gross domestic product at factor cost includes depreciation while net domestic product at factor cost does not include depreciation.

4. When will GDP of an economy be equal to GNP?

Ans: GDP and GNP will be equal when the 'net factor income from abroad' is zero.

5. When will the domestic income exceed the national income?

Ans: When the net factor income from abroad is negative.

6. If NDPFC is Rs 1,0000 crores and NFIA is (-) Rs 500 crores, how much will be the national income?

Ans: National Income = 10000 + (-500)
= Rs 9500 Crore

7. If the domestic factor income is Rs 50,000 crores and the national income is Rs 45,000 crores, how much will be the net factor income from abroad?

Ans: Net factor income from abroad = 45,000 - 50,000 = (-) Rs 5000 Crore

8. Mention the three methods of measuring national income.

Ans:

1. Value added method
2. Income method
3. Expenditure method.

9. Calculate the disposable income, if personal income is Rs 30,000 and the rate of income tax is 10%.

Ans: Disposable Income = 30,000 – (10% of 30,000) = ₹27,000

10. In which type of economy, domestic income will be equal to national income?

Ans: Closed economy.

11. What is the value added method of measuring national income?

Ans: Value added method is the method that measures the national income by estimating the value added by each producing enterprises within the domestic territory of the country in an accounting year.

12. When is value of output equal to value added?

Ans: Value of output is equal to value added if there are no intermediate costs.

13. What aggregate do we get when we add up the gross value added of all the producing sectors of an economy?

Ans: Gross domestic product at market price.

14. What is the rationale for not taking into account the value of intermediate goods in the measure of GDP?

Ans: To avoid the problem of double counting.

15. If compensation of employees in a firm constitutes 65% of net value added at factor cost of a firm, find the proportion of operating surplus.

Ans: 100% – 65% = 35% (assuming mixed income is zero).

16. What is nominal gross domestic product? [CBSE Delhi 2011]

Ans: When gross domestic product (GDP) of a given year is estimated on the basis of price of the same year, it is called nominal GDP.

17. Define primary sector. [CBSE AI2013,]

Ans: It is the sector that produces goods by exploiting natural resources like land, water, forests, mines, etc. This sector includes agricultural and allied activities, fishing, mining and quarrying.

18. Define secondary sector.

Ans: It is called manufacturing sector also. Enterprises in this sector transform one type of commodity into another type of commodity. For example: leather goods from leather, flour from wheat, sugar from sugarcane, etc.

19. Define tertiary sector.

Ans: It is known as service sector also. Enterprises in this sector produce services only. Examples are banking, transport, communications etc.

II. MULTIPLE CHOICE QUESTIONS (1 Mark)

1. Which one of the following statements is incorrect?

(a) GDP at market price = GDP at factor cost plus net indirect taxes.

(b) NNP at factor cost = NNP at market price minus indirect taxes.

(c) GNP at market price = GDP at market price plus net factor income from abroad.

(d) None of them.

Ans: (a)

**2. National income differs from net national product at market price by the amount—
—.**

(a) current transfers from the rest of the world

(b) net indirect taxes

(c) national debt interest

(d) it does not differ

Ans: (b)

3. Net national product at factor cost is———.

(a) equal to national income

(b) less than national income

(c) more than national income

(d) sometimes less than national income and sometimes more than it

Ans: (a)

**4. The net values added method of measuring national income is also known as———
—.**

(a) net output method

(b) production method

(c) industry of origin method

(d) all of the above

Ans: (d)

5. Identify the item which is not a factor payment:

(a) Free uniforms to defense personnel

(b) Salaries to the members of Parliament

(c) Imputed rent of an owner occupied a building .

(d) Scholarships given to the students of scheduled caste

Ans: (d)

6. Mixed income of the self-employed means

(a) gross profits received by proprietors

(b) rent, interest and profit of an enterprise

(c) combined factor payments which are not distinguishable

(d) wages due to family workers

Ans: (c)

7. Demand for final consumption arises in ———.

(a) household sector only

(b) government sector only

(c) both household and government sectors

(d) neither in households nor in government sector

Ans: (c)

8. Demand for intermediate consumption arises in——— .

(a) consumer households

(b) government enterprises only

- (c) corporate enterprises only
- (d) all producing sectors of an economy

Ans: (d)

9. Which one of the following options is an economic activity?

- (a) Listening to music on the radio.
- (b) Teaching one's own son at home.
- (c) Medical facilities rendered by a charitable dispensary.
- (d) A housewife doing household duties.

Ans: (c)

10. Net value added is equal to----- .

- (a) payments accruing to factors of production
- (b) compensation to employees
- (c) wages plus rents
- (d) value of output minus depreciation

Ans: (a)

11. Per capita national income means:

- (a) NNP/population
- (b) Total capital population
- (c) Population NNP
- (d) None of them

Ans: (a)

12. Which one of the following statements is correct?

- (a) If national income rises, per capita income must also rise
- (b) If population rises, per capita income must fall.
- (c) If national income rises, welfare of the people must rise.
- (d) None of them

Ans: (d)

III. SHORT ANSWER TYPE QUESTIONS (3-4 Marks)

1. Distinguish between domestic product and national product. When can domestic product be more than national product? [CBSE (AI) 2009]

OR

Differentiate between Domestic Income (NDPFC) Vs National Income (NNPFC).

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Domestic product will be greater than national product when net factor income from abroad is negative.

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2. Differentiate between Gross Domestic Product at Market Price Vs National Income.

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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3. Differentiate between National Income at constant price and national income at current price?

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

4. Distinguish between real and nominal gross domestic product.[CBSE(AI) 2010]

Or

Discuss any two differences between GDP at constant prices and GDP at current Prices.[CBSE Sample Paper 2016]

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

5. Explain how ‘externalities’ are a limitation of taking gross domestic product as an index of welfare. [CBSE Foreign 2011]

Ans:

1. When the activities of somebody result in benefits or harms to others with no payment received for the benefit and no payment made for the harm done, such benefits and harms are called externalities.
2. Activities resulting in benefits to others are positive externalities and increase welfare; and those resulting in harm to others are called negative externalities, and thus decrease welfare.
3. GDP does not take into account these externalities.
4. For example, construction of a flyover or a highway reduces transport cost and journey time of its users who have not contributed anything towards its cost. Expenditure on construction is included in GDP but not the positive externalities flowing from it. GDP and positive externalities both increase welfare. Therefore, taking only GDP as an index of welfare understates welfare. It means that welfare is much more than it is indicated by GDP.
5. Similarly, GDP also does not take into account negative externalities. For examples, factories produce goods but at the same time create pollution of water and air. River Yamuna, now a drain, is a living example. The pollution harms people. The factories are not required to pay anything for harming people. Producing goods increases welfare but creating pollution reduces welfare. Therefore, taking only GDP as an index of welfare overstates welfare. In this case, welfare is much less than indicated by GDP.

6. Explain how “Non-Monetary exchanges’ are a limitation in taking gross domestic product as an index of welfare.[CBSE(AI) 2011]

Ans:

1. There are many goods and services which are left out of estimation of national income on account of practical estimation difficulties e.g., services of housewives and other members, own account production, etc.
2. These are left on account of non-availability of data and problem in valuation.
3. It is generally agreed that these items contribute to economic welfare.
4. So, if we depend only on GDP, we would be underestimating economic welfare.

7. Explain how distribution of 'Gross Domestic Product' is a limitation in taking gross domestic product as an index of welfare.[CBSE Delhi 2010, 2011]

Ans:

1. All people do not earn the same amount of income. Some earn more and some earn less. In other words, there is unequal distribution of income.
2. At the same time, it is also true that in the event of rise in 'per capita real income' all are not better off equally. 'Per capita' is only an average. Income of some may rise by less and of some by more than the national average. In case of some it may even fall.
3. It means that the inequality in the distribution of income may increase or decrease.
4. If it increase it implies that rich become more rich and the poor become more poor.
5. Utility of a rupee of income to the poor is more than to the rich. Suppose, the income of the poor declines by one rupee and that of the rich increases by one rupee. In such a case, the decline in welfare of the poor will be more than the increase in welfare of the rich.
6. Therefore, if the rise in per capita real income inequality increases, it may lead to a decline in welfare (in the macro sense).

8. State the various components of the income method that are used to calculate national income.[CBSE Sample Paper 2014]

Ans:

1. **Compensation of employees:** The amount earned by employees from their employer, whether in cash or in kind or through any other social security scheme is known as compensation of employees.
2. **Operating Surplus:** It is the sum of income from property and income from entrepreneurship.
3. **Mixed Income:** Income of own account workers (like farmers, doctors, barbers, etc.) and unincorporated enterprises (like small shopkeepers, repair shops) is known as mixed income.
Note: (i) To estimate amount of factor payments made by each producing unit.
(ii) To add all factor incomes/payments within domestic territory to get domestic income, i.e., NDPFC.
$$\text{NDPFC} = \text{Compensation of employees} + \text{Operating Surplus} + \text{Mixed Income}$$
4. **Net factor income from Abroad(NFIA):** NFIA is the difference between income earned by normal residents from rest of the world and similar payments made to Non residents within the domestic territory. Addition of NFIA to NDPFC to get NY, i.e., NNPPc.
$$\text{NNPFC} = \text{NDPFC} + \text{NFIA}$$

9. Define double counting. How can the problem of double counting be avoided?

Ans: If a single transaction is recorded twice or more than twice in the calculation of national income, then it is known as double counting.

The problem of double counting is solved by value added method. Theoretically to avoid double counting there may be two alternative ways:

1. Final Product Approach
2. Value Added Approach

1. **Final Product Approach:** According to this, value of only final products, i.e. which go for final consumption or capital formation should be included. But in practical application of this approach double counting still creeps in as every producer treats the product he sells as final whereas the same might have been used as intermediate product by the buyer.
2. **Value Added Approach:** Value added method is most effective in avoiding double counting. According to this, instead of taking value of final goods, only value added at each stage of production by a producing unit is taken. Value added of a firm by subtracting intermediate consumption from value of output.

IV. TRUE OR FALSE

Giving reasons, state whether the following statements are true or false.

1. In a closed economy, gross national product is always equal to gross domestic product.

Ans: True: When net factor income from abroad is zero i.e., income from abroad is equal to income to abroad.

2. Gross investment can be equal to net investment.

Ans: True: It is possible when depreciation is zero.

3. Domestic Income of a country can be more than its National income.

Ans: True: It can happen when NFIA is negative i.e., factor income paid to abroad is more than factor income received from abroad.

4. Market price is always more than factor cost.

Ans: False: Market price can be less than factor cost if net indirect taxes (NIT) are negative. Market price can also be equal to factor cost if NIT is zero.

5. Measurement of national income at current prices provides a reliable base of comparison.

Ans: False: National Income at 'Constant Prices' provides a reliable base of comparison.

6. Nominal GDP can never be less than Real GDP.[CBSE Sample Paper 2010]

Ans: False: Nominal GDP can be less than real GDP, if prices in the current year are less than the prices in the base year.

7. Net capital gains from the sale of property is a part of domestic factor income.

Ans: False: It is not a part of domestic factor income. It is a sale of property and not of factors.

8. Change in stock is not a part of Capital formation.

Ans: False: Change in stock is a part of domestic capital formation.

9. Brokerage paid on sale of shares and income from shares purchased is not a part of national income.

Ans: False: Brokerage paid on sale of shares or any other item is a part of national income.

10. Salary of Pakistan worker, working in Indian Embassy is not a national income of India.

Ans: True: It is an expenditure made by- Indian Embassy. It is a part of Indian domestic income.

11. Income tax paid is not a part of national income.

Ans: False: Income tax paid is part of national income. It is included in profit and individual income.

12. Income from imputed rent of self- occupied houses is a part of national income.

Ans: True: It is an estimated amount of . rent. If rented to any other person, he would receive the amount of rent.

13. Net profit of any Bank of India's branch in USA will not be included in Indian National income.

Ans: False: Net profit of any Bank of India at USA branch is a part of national income of India.

14. Exports do not form a part of domestic factor income.

Ans: False: Exports are made from domestic production. It is a part of domestic factor income.

15. Gross domestic product at market price includes net factor income from abroad and net indirect taxes.

Ans: False: GDPMP does not include net factor income from abroad but includes net indirect taxes.

16. Gross National Product is always less than Gross National expenditure.

Ans: False: Gross national product is always equal to gross national expenditure.

17. Exports are a part of net factor income from abroad.

Ans: False: Exports are a part of domestic income. Exports are sent from home production.

18. Real GDP includes domestic income at current prices.

Ans: False: Real GDP is taken at some constant prices. It does not have the influence of price fluctuations.

19. National disposable income includes current transfers income of government.

Ans: False: National income includes income of government sector in the form of receiving of taxes.

20. Private income does not include net factor income from abroad.

Ans: False: Private income is a national concept. It also includes net factor income from abroad.

21. Personal income does not include income from personal taxes.

Ans: False: Personal income includes personal taxes, but not corporate taxes.

22. Personal disposable income is equal to aggregate consumption and savings.

Ans: True: Personal disposable income can be disposed upon consumption and savings both.

23. Private income includes earned incomes of private sector from all sources.

Ans: False: Private income includes both earned income (factor income) as well as unearned income (transfer income) of private sector from all sources.

24. National disposable income is the disposable income of private sector.

Ans: False: It is the disposable income of the whole country (public sector and private sector).

25. Travelling allowance paid by employer is a part of national income.

Ans: False: Travelling allowances are paid by an employee and then recovered from employer. It is not a part of national income

26. Consumption of food grains by farmer himself is not a part of national output.

Ans: False: It is a part of domestic output. It is a part of national income.

27. Sale of second hand car is not included in national income.

Ans: True: It's original sale has already been included in national income of previous year. If done it will be case of double counting.

28. Rent received by an American from Reliance Industries with respect to building located in India will neither be included in national income nor in domestic income of India.

Ans: False: Such rent will be included in domestic income of India as building is located within the domestic territory of India

29. Purchase of car by a consumer is a part of gross domestic capital formation.

Ans: False: It is a part of private final consumption expenditure.

30. Goods produced for self-consumption will be included in national income.

Ans: True: Such goods contribute to the current output and their imputed value will be included in national income.

31. Gross domestic capital formation is always greater than gross fixed capital formation. [CBSE Sample Paper 2010]

Ans: False: Gross domestic capital formation can be less than gross fixed capital formation if change in stock is negative.

Note: As per CBSE guidelines, no marks will be given if reason to the answer is not explained.

V. LONG ANSWER TYPE QUESTIONS(6 Marks)

1. Calculate GNP at FC from the following data by

- 1. income method, and**
- 2. expenditure method. [CBSE 2002]**

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Ans:

- NDPFC = Compensation of employees (Wages and salaries + Employer's contribution towards social security scheme) + Operating Surplus + Mixed Income

$$= [(i) + (viii)] + (iii) + (ii)$$

$$= [800 + 100] + 600 + 160 = 900 + 600 + 160 = 1660 \text{ Crore}$$

GNPFC = NDPFC + Depreciation (Gross capital formation – Net capital Formation) + Net Factor Income from abroad = 1660 + [(H) – (nil) + (6c)]

$$= 1660 + [330 - 300] + (-20)$$

$$= 1660 + 30 - 20 = 1670 \text{ Crore}$$
- GDPMP = Government final consumption expenditure (Public final consumption expenditure) + Private final consumption expenditure + Gross domestic Capital formation + Net export (Export – Import)

$$= (xiii) + (xii) + (v) + [(x) - (xi)]$$

$$= 450 + 1000 + 330 + [30 - 60]$$

$$= 1750 \text{ Crore .}$$

GNPFC = GDPMP + Net factor income from abroad – Net Indirect Tax = 1750 + (be) – (xiv)

$$= 1750 + (-20) - 60 = 1750 - 20 - 60 = 1670 \text{ Crore}$$

2. Calculate “Gross National Product at Factor Cost” from the following data by (a) Income method, and (b) Expenditure method:[CBSE 2009]

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Ans: NDPFC = Compensation of Employees + Operating Surplus(profit + Rent + Interest + Mixed Income

$$= (\text{iv}) + [(\text{iii}) + (\text{v}) + (\text{viii})] + 0 = 800 + [400 + 250 + 150]$$

$$= 800 + 800 = 1600 \text{ Crore GNPFC} = \text{NDPFC} + \text{Depreciation (Consumption of fixed Capital)} + \text{Net factor Income from abroad} = 1600 + (\text{vii}) + (\text{x})$$

$$= 1600 + 60 + (-10) = 1650 \text{ Crore GDPMP} = \text{Government final consumption expenditure} + \text{Private final consumption expenditure} + \text{Gross domestic capital formation (Net domestic capital formation} + \text{consumption of fixed capital)} + \text{Net export} = (\text{x}) + (\text{i}) + [(\text{ii}) + (\text{vii})] + (\text{xi})$$

$$= 500 + 1000 + [200 + 60] + (-20)$$

$$= 500 + 1000 + 260 - 20 = 1740 \text{ Crore GNPFC} = \text{GDPMP} + \text{Net factor income from abroad} - \text{Net Indirect Tax}$$

$$= 1740 + (\text{x}) - (\text{xii})$$

$$= 1740 + (-10) - 80 = 1650 \text{ Crore}$$

3. From the following data, calculate (a) Gross Domestic Product at Factor Cost and (b) Factor Income To Abroad:[CBSE 2010]

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Ans: (a) NDPFC = Compensation of employees + Operating surplus (Profit + Rent + Interest) + Mixed income
= (i) + P) + (v) + M] + 0 = 800 + [200 + 150 + 100]
= 800 + 450 = 1250 Crore Note: Gross domestic capital formation = Net fixed capital formation + Depreciation + Change in stock (vii) = (viii) + Depreciation + (ix)
300 = 200 + Depreciation + 50 Depreciation = 300 - 250 = 50 GDPFC = NDPFC + Depreciation = 1250 + 50 = 1300 Crore (b) GNPMP = GDPFC + NFIA (Factor income from abroad - Factor income paid to abroad) + Net indirect tax (iv) = 1300 + [(x) - Factor income paid to abroad] + (xi)
1400 = 1300 + (60 - Factor income paid to abroad) + 120 1400 = 1480 - Factor income paid to abroad
Factor income paid to abroad = 1480 - 1400 = 80 Crore

4. Calculate (a) Private Income and (b) Gross Domestic Product at Factor Cost: [CBSE 2013, C, Set-I]

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Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Ans: Personal Disposable Income = Personal income – Direct taxes paid by households – Miscellaneous receipts of government
 $(xi) = \text{Personal Income} - (iv) - (i)$
 $200 = \text{Personal income} - 30 - 5$ Personal Income = 235 Arab
Private Income = Personal Income + Retained profits (Savings of private corporate sector) + Corporate Tax = $235 + (iii) + (ii)$
 $= 235 + 10 + 20 = 265$ Arab „ Private income = NNPF – Income from Domestic Product Accruing to Public Sector (Income from Property and Entrepreneurship accruing to government Administrative Departments + Saving of Non Departmental Enterprises) + National Debt interest + Current transfers from Government + Net Current transfers from rest of the world ,
 $265 = \text{NNPF} - [(x) + (ii)] + (viii) + (ix) + (vii)]$
 $265 = \text{NNPF} - (12 + 3) + 15 + 8 + 4$
 $\text{NNPF} = 265 + 15 - 27 = 253$ Arab
 $\text{GDPFC} = \text{NNPF} + \text{Consumption of fixed capital} - \text{Net factor income from abroad}$
 $= 253 + (xii) - [-(v)]$
 $= 253 + 11 + 6 = 270$ Arab

5. Calculate (a) Private Income and (b) National Income:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Ans: Personal Disposable Income = Personal Income – Direct Taxes paid by households – Miscellaneous receipts of Government

(i) = Personal Income - (v) - (iii)

120 = Personal income – 15 – 4 Personal Income = 139 Arab (Billion) Private Income = Personal Income + Undistributed profits of private sector + Corporate Tax = 139 + (vii) + (vi)

= 139 + 3 + 6 = 148 Arab Private income = NNPFPC – Income from Domestic Product Accruing to Public Sector (Income from Property and Entrepreneurship accruing to Government Administrative Departments + Saving of Non-Departmental Enterprises) + National Debt interest + Current transfers from government + Net Current transfers from rest of the world

148 = NNPFPC – [(ii) + (ix)] + (viii) + (xi) + (iv) ,

148 = NNPFPC - (5 + 15) + 16 + 2 + 10

NNPFPC = 148 + 20 – 28 = 140 Arab

6. Find out Gross National Product at Market price and Net National Disposable Income from the following:

Ans: GDPMP = Government final consumption expenditure + Private final consumption expenditure + Gross domestic Capital formation (Net domestic Fixed capital formation + consumption of fixed capital + Change in stocks (closing stock – opening Stock) + Net Export = (vi) + (ii) + {(ix) + (vii) + [(iv) – (i)]} + (-viii) = 300 + 1000 + {150 + 30 + [40 - 50]} + (-20) = 300 + 1000 + 170 – 20 = 1450 Arab

GNPMP = GDPMP + Net factor income from abroad = 1450 + (-v)

= 1450 + [- (-10)] = 1460 Arab NNPFPC = GNPMP – consumption of fixed capital – net indirect tax = 1460 – (vii) – 0 = 1460 – 30 = 1430 Arab

NNDI = NNPFPC + NIT + Net current transfer from rest of the world (abroad) = 1430 + 0 + (-iii)

= 1430 + (-5) = 1425 Arab

VI. HIGHER ORDER THINKING SKILLS

1. Explain the components of NFIA. [3-4 Marks]

Ans: There are three components of NFIA.

1. **Net Compensation of Employees:** The net compensation of employees receivable from the rest of the world is equal to the difference between compensation of employees received by resident workers who are living temporarily abroad or are employed abroad, and similar payments made to non-resident workers that are temporarily staying or are employed within the domestic territory of the country.
2. **Net Income From Property and Entrepreneurship:** Net income from property and entrepreneurship is equal to the difference between the income received by way of interest, rent and profits by the residents of a country and similar payments made to the rest of the world.
3. **Net Retained Earnings of Resident Companies Abroad:** Retained earnings refers to the undistributed profits of the companies. Resident companies (i.e. companies belonging to one country and working in the domestic territory of some other country) retain a part of their profits for further investment abroad. Likewise, foreign companies and their branches retain a part of their profits in the countries of their operation.

The difference between the retained earnings of resident companies located abroad and retained earnings of the foreign companies located in a country is equal to the net retained earnings from abroad.

Note: It must be noted that NFIA is zero in a closed economy as such economy does not deal with the rest of the world sector.

2. Differentiate between National income and Private income. [3-4 Marks]

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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VII. VALUE BASED QUESTIONS

1. Why do non market economic activities, like

1. **Services of housewives**
2. **Voluntary services and**
3. **Leisure time activities**

help in the flow of goods and services of a country. But why are these not included in the estimation of national income? [1 Mark]

Ans: They are not included in national income, because of non-availability of data and problem in measuring the proper monetary values of these services.

Value : Implication of knowledge.

2. The given set of prices which is used for finding out real per capita income, should change frequently. Why? [1 Mark]

Ans: If the given set of prices used for assessing real per capita income changes frequently, then virtually what we get is nominal per capita income and this defeats the purpose of using or calculating the real per capita income.

Value : Critical thinking

3. Why comparing the GDPs of various nations might not tell you which nation is better off? [1 Mark]

Ans: The well being of nation or standard of living of people is measured by per capita income (GDP / Total Population) and distribution pattern of income not only by GDP.

Value : Critical thinking

4. GDP Calculation do not directly include the social costs of environmental damages, for example, global warming, acid rain. Do you think these costs should be included in GDP? Why or Why not? [1 Mark]

Ans: Yes, because people's well-being is affected by these environmental damages. No, it is very difficult to assess real damages in monetary terms.

Value : Awareness about social cost of GDP.

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5. GDP growth rate in India for the last few years is more than 6% but still more than 28% of population is lying below poverty line. Explain any two factors responsible for it. [1 Mark]

Ans: There are two factors,

1. Unequal distribution of GDP
 2. Rise in price level
- Value :** Social awareness

6. Should we take real per capita income as an index of economic welfare? If not, why? [1 Mark]

Ans: Real per capita income cannot be taken as an index of economic welfare because there are many items and transactions relating to national income that have no connection with real GDP such as production of defence goods. Also it does not take into account any transaction related to illegal activities, black money and production of services for self-consumption.

Value : Critical thinking

7. Rakesh pays Rs 1,000 towards premium on his full life policy with the LIC. Is this a part of compensation of employees? [1 Mark]

Ans: No, any contribution made by an employee himself to any insurance scheme is not a part of compensation to employee. Value: Analytic

8. How will you treat Rs 20,000 earned per month by Mr Rajesh against hiring out his bus to a neighboring school?[1 Mark]

Ans: Income earned by way of lease is rental income, and hence form part of operating surplus and is included in national income.

Value: Analytic



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1. What is Barter system? What are its drawbacks? [3 Marks]

Ans: Barter system of exchange is a system in which goods are exchanged for goods.
It's Drawbacks are:

1. Lack of double coincidence of wants.
2. Lack of divisibility.
3. Difficulty in storing wealth.
4. Absence of common measure of value.
5. Lack of standard of deferred payment.

2. What are the main functions of money? How does money overcome the shortcoming of a barter system?

[6 Marks] Or

Explain the problem of double coincidence of wants faced under barter system. How has money solved it? [CBSE 2013]

Ans:

1. "Money is a matter of the following four functions: A medium, a measure, a standard, a store".
2. Money has overcome the short-coming of a barter system in the following manner:

(a) Medium of exchange

- Under barter system, there is lack of double coincidence of wants.
- With money as a medium exchange individuals can exchange their goods and services for money and then use this money to buy other goods and services according to their needs and conveniences.
- A buyer can buy goods through money and a seller can sell goods for money.

(b) Measure of value

- Under barter system, there was no common measure of value. Money has also solved this difficulty.
- As Geoffrey Crowther puts it, "Money acts as a standard measure of value to

which all other things can be compared.” Money measures the value of economic goods.

- Money works as a common denominator into which the values of all goods and services are expressed.
- When we express the values of a commodity in terms of money, it is called price and by knowing prices of the various commodities, it is easy to calculate exchange ratios between them.

(c) Store of value

- Under barter system it is very difficult to store wealth for future use.
- Most of the goods are perishable and their storage requires huge space and transportation cost.
- Wealth can be conveniently stored in the form of money.
- Money can be stored without loss in value.
- Money can easily be stored for future use.

(d) Standard of deferred payments

- Under barter system, transactions on deferred payments are not possible.
- With money, the debtors make a promise that they will make payments on some future dates. In those situations money acts as a standard of deferred payments.
- It has become possible because money has general acceptability, its value is stable, it is durable and homogeneous.

3. What is transaction demand for money? How is it related to the value of transactions over specified period of time?

Ans: Deleted from syllabus.

4. Why is speculative demand for money inversely related to the rate of interest?

Ans: Deleted from syllabus

5. What are the alternative definitions of money supply in India?[3-4 Marks]

Ans: The alternative definitions of money supply in India can be the four measures of money supply. They are explained as under:

Measures of M_1 include:

1. Currency notes and coins with the public (excluding cash in hand of all commercial banks) [C]
2. Demand deposits of all commercial and co-operative banks excluding inter-bank deposits. (DD),
Where demand deposits are those deposits which can be withdrawn by the depositor at any time by means of cheque. No interest is paid on such deposits.
3. Other deposits with RBI [O.D]

$M_1 = C + DD + OD$ Where, Other deposits are the deposits held by the RBI of all economic units except the government and banks. OD includes demand deposits

of semi-government public financial institutions (like IDBI, IFCI, etc.), foreign central banks and governments, the International Monetary Fund, the World Bank, etc.

Measures of M_2

1. $M_1[C + DD + OD]$
2. Post office saving deposits

Measures of M_3

1. M_1
2. Time deposits of all commercial and co-operative banks.
Where, Time deposits are the deposits that cannot be withdrawn before the expiry of the stipulated time for which deposits are made. Fixed deposit is an example of time deposit.

Measures of M_4

1. M_3
2. Total deposits with the post office saving organization (excluding national savings certificates).

6. What is a 'legal tender'? What is 'fiat money'?

Ans:

1. **Legal tender:**
(a) Legally, money is anything proclaimed by law as a medium of exchange.
(b) Paper notes and coins (together called currency) is money as a matter of law.
(c) Nobody can refuse its acceptance as medium of exchange.
2. **FIAT Money:** It is defined as a money which is under the 'FIAT' (order/authority) of the government to act as a money.

7. What is High powered money?

Ans: It is money produced by the RBI and the government. It consists of two things:

1. currency held by the public and
2. Cash reserves with the banks.

MORE QUESTIONS SOLVED

I.VERY SHORT ANSWER TYPE QUESTIONS (1 Mark)

1. Define Barter system.

Ans: Barter system of exchange is a system in which goods are exchanged for goods.

2. What is meant by double coincidence of wants?

Ans: Double coincidence of wants means that goods in possession of two different persons must be useful and needed by each other.

3. Define Money.

Ans: Money is something which is generally acceptable as a medium of exchange and can be converted into other assets without losing its time and value.

4. What is the basic characteristic of money?

Ans: Durability and weight.

5. What is the legal definition of money?

Ans: Legally, money is anything proclaimed by law as a medium of exchange. Paper notes and coins (together called currency) is money as a matter of law.

6. Define money supply.[CBSE Foreign 2004, 2031]

Ans: The stock of money held by the public at a point of time, in an economy, is referred to as the money supply. Money supply is a stock concept.

7. What items are included in the M_3 measure of money supply?

Ans:

1. M_3 (currency notes and coins with public + demand deposits of commercial and co-operative banks + other deposits with RBI),
2. Time deposits of all commercial and co-operative banks.

8. State two components of money supply. [CBSE Sample Paper 2010] Or State the components of money supply. Or [CBSE 2010]

What is included in money supply?[CBSE 2010C, 2011]

Ans: Currency notes and coins with public + demand deposits with the banks.

9. Define demand deposits.[CBSE 2013, Set I, HOTS]

Ans: Demand deposits are those deposit which can be withdrawn by the depositor at any time by means of cheque. No interest is paid on such deposits.

10. What are time deposits in banks?[AI 2013, C Set I]

Ans: Time deposits are the deposits which can not be withdrawn before the expiry of the stipulated time for which deposits are made. Fixed deposit is an example of time deposit.

11. State the components of supply of money. [AT 2013 Set I]

Ans:

1. Coins and currency notes with public.

2. Demand deposits with banks.

II.MULTIPLE CHOICE QUESTIONS(1 Mark)

1. M1 in the money stock in India refers to:

- (a) Post office savings deposits.
- (b) Total post office deposits.
- (c) Currency plus demand deposits plus other deposits with the RBI.
- (d) Time deposits with banks.

Ans:(c)

2. Narrow money refers to:

- (a) M₁ (b) M₂
- (c) M₃ (d) M₄

Ans: (a)

3. Broad money refers to:

- (a) M₁ (b) M₂
- (c) M₃ (d) M₄

Ans: (c)

4. The basic distinction between narrow and broad money is the

- (a) treatment of post office deposits
- (b) treatment of time deposits of banks
- (c) treatment of savings deposits of banks
- (d) treatment of currency

Ans:(b)

5. Read the following dialogue between two people:

Sita : I want 1 kg of potatoes

Rani : What will you give in exchange?

Sita : I can give you 2 litres of milk in return for the potatoes.

Rani: I don't need milk. I want a pair of shoe

Which of the following problems is being faced by Sita and Rani in their exchange process?

- (a) Lack of double coincidence of wants
- (b) Absence of common units of value
- (c) Lack of store of value
- (d) Lackl of standard of deferred payment.

Ans: (a)

6. Which of the following agency is responsible for issuing ? 1 currency note in India?[CBSE Sample Paper 2016]

- (a) Reserve Bank of India
- (b) Ministry of Commerce

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(c) Ministry of finance

(d) Niti Aayog

Ans:(c)

III. SHORT ANSWER TYPE QUESTIONS [3-4 Marks]

1. Explain the ‘medium of exchange’ function of money.[CBSE Delhi 2014, AI 2013]

Ans:

1. Money when used as a medium of exchange helps to eliminate the basic limitation of barter trade, that is, the lack of double coincidence of wants.
2. Individuals can exchange their goods and services for money and then can use this money to buy other goods and services according to their needs and convenience.
3. Thus, the process of exchange shall have two parts: a sale and a purchase.
4. The ease at which money is converted into other goods and services is called “liquidity of money”.

2. Explain the ‘Unit of account’ function of money. [CBSE 2004C; AI 2007]

Ans:

1. Another important function of money is that it serves as a common measure of value or a unit of account.
2. Under barter economy there was no common measure of value in which the values of different goods could be measured and compared with each other. Money has also solved this difficulty.
3. As Geoffrey Crowther puts it, “Money acts as a standard measure of value to which all other things can be compared.” Money measures the value of economic goods.
4. Money works as a common denominator into which the values of all goods and services are expressed.
5. When we express the values of a commodity in terms of money, it is called price and by knowing prices of the various commodities, it is easy to calculate exchange ratios between them.

3. Explain Standard of deferred payments function of money.[CBSE Delhi 2004 C, 2007, 2012, Sample Paper 2013]

Ans:

1. Credit has become the life and blood of a modern capitalist economy.
2. In millions of transactions, instant payments are not made.
3. The debtors make a promise that they will make payments on some future date. In those situations money acts as a standard of deferred payments.

4. It has become possible because money has general acceptability, its value is stable, it is durable and homogeneous.

4. Explain Store of value function of money.[CBSE 2006, 2006C, 2007; AI 2007, 2013 C, Sample Paper 2013]

Ans:

1. Wealth can be conveniently stored in the form of money. Money can be stored without loss in value.
2. Savings are secured and can be used whenever there is a need.
3. In this way, money acts as a bridge between the present and the future.
4. Money means goods and services. Thus, money serves as a store of value.
5. It is also known as asset function of money.

5. Explain the problem of double coincidence of wants faced under barter system. How has money solved it? [CBSE 2013 (Set-I)]

Ans:

1. Under barter system, there is lack of double coincidence of wants.
2. With money as a medium exchange individuals can exchange their goods and services for money and then use this money to buy other goods and services according to their needs and conveniences.
3. A buyer can buy goods through money and a seller can sell goods for money.

IV.TRUE OR FALSE

Giving reasons, state whether the following statements are true or false.

1. Standard of deferred payments led to capital formation and economic development of the economy.

Ans: True. It is so because credit has become the life and blood of a modern capitalist economy that leads to economic development of the country.

2. Measure of value function has removed the difficulty of lack of double coincidence of wants.

Ans: False. Medium of exchange function has removed the difficulty of lack of double coincidence of wants.

3. Store of value function of money facilitates transfer of purchasing power from present to future.

Ans: True. It facilitates transfer of purchasing power from present to future.

4. Money supply is a stock concept.

Ans: True. Money supply is a 'stock concept' as it is measured at a particular point of time.

5. M_1 includes time deposits of commercial banks.

Ans: False. M_1 includes currency notes and coins, demand deposits of commercial and cooperative banks and other deposits. Time deposit is a component of M_3 .

6. Money supply does not include money held by government and banking system.

Ans: True. As money held by them do not come into actual circulation in the country.

7. Lack of double coincidence of wants exists in barter exchange difficulty in simultaneous fulfilment of mutual wants of buyers and sellers.

Ans: True. It exists under barter exchange because of difficulty in simultaneous fulfilment of mutual wants of buyers and sellers.

Note: As per CBSE guidelines, no marks will be given if reason to the answer is not explained.

V. HIGHER ORDER THINKING SKILLS

1. Define high-powered money. [1 Mark]

Ans: High-powered money is money produced by the RBI and the government. It consists of two things:

1. Currency held by the public and
2. Cash reserves with the banks.

2. What are other deposit measures of M_1 ? [1 Mark]

Ans: Other deposits are the deposits held by the RBI of all economic units except the government and banks. OD includes demand deposits of semi-government public financial institutions (like IDBI, IFCI, etc.), foreign central banks and governments, the International Monetary Fund, the World Bank, etc.

3. Why post office saving are less liquid than demand deposits? [1 Mark]

Ans: Post office saving banks are not as liquid as demand deposits with the banks (commercial or cooperative) as they are not chequeable account. However, saving deposits with post offices are more liquid than time deposits with the banks.

4. Explain why time deposits measures of M_3 is less liquid than the demand deposits measure of M_1 [3 Marks]

Ans:

1. It is generally thought that time deposits with the banks are not as liquid as demand deposits, because the time deposits are not chequeable (i.e., these cannot be withdrawn through cheques drawn on them).
2. However, loans against these time deposits can be easily taken. Hence, they can be used in times of need.

3. Moreover, they can also be withdrawn at any time by forgoing some interest earned on them.

5. What are the characteristics or features of money? [3 Marks]

Ans:

1. **Durability:** Money must be durable and not likely to deteriorate rapidly with frequent handling. Currency notes and coins are being used repeatedly and shall continue to do so for many years.
2. **Medium of exchange:** Money is the thing that acts as a medium of exchange for the sale and purchase of goods and services.
3. **Weight:** Money must be light in weight. Paper money is better than metal coins because it is light in weight.
4. **Measure of value:** It not only serves as medium of exchange but also acts as a measure of value. The value of all the goods and services is expressed in terms of money. [1 Mark]

VI. VALUE BASED QUESTIONS

1. Why is the use of money more convenient for exchange than barter system? Explain. [3 Marks]

Ans:

1. Medium of Exchange
2. Store of Value
3. Standard of deferred payment Value: Empathy

2. Why do all the compensations in form of money than toys more convenient to an employee working in a toy manufacturing factory? [1 Mark]

Ans: There is lack of general acceptability in case of toys, while in the case of money there is general acceptability; so, he can purchase any goods and services with the help of money at any point of time and he does not have to face any problem of lack of double coincidence of wants.

Value: Empathy

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1. Explain the functions of a commercial bank?

Ans: Deleted from syllabus.

2. What is money multiplier? How will you determine its value? What ratios play an important role in the determination of the value of the money multiplier? [3-4 Marks]

Ans:

1. When the primary cash deposit in the banking system leads to multiple expansion in the total deposits, it is known as money multiplier or credit multiplier.
2. The value of Money Multiplier

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

where LRR = Legal Reserve Ratio.

3. Legal Reserve Ratio: It is the minimum ratio of deposits legally required to be kept by the commercial banks with themselves and with the central bank.
4. So, there are two ratios which play an important role in the determination of the value of the money multiplier. They are:
(a) Cash Reserve Ratio: It refers to the minimum percentage of a bank's total deposits, which it is required to keep with the central bank.
(b) Statutory Liquidity Ratio: It refers to minimum percentage of net total demand and time liabilities, which commercial banks are required to maintain with themselves.

3. What are the instruments of monetary policy of RBI? How does RBI stabilize money supply against exogenous shocks? [6 Marks]

Ans:

1. Principal instruments of Monetary Policy or credit control of the Central Bank of a country(RBI) are broadly classified as:
 - (a) Quantitative Instruments,
 - Bank Rate
 - Repo rate
 - Reverse Repo rate
 - Open Market Operations (OMO)
 - Varying Reserve Requirements (fa) Qualitative Instruments
 - Imposing margin requirement on secured loans
 - Moral Suasion
 - Selective Credit Controls (SCCs)
 2. RBI stabilize money supply against exogenous shocks in the following manner:
 - (a) Bank Rate (Discount Rate)
 - Bank rate is the rate of interest at which central bank lends to commercial banks without any collateral (security for purpose of loan). The thing, which has to be remembered, is that central bank lends to commercial banks and not to general public.
 - In a situation of excess demand leading to inflation,
 - > Central bank raises bank rate that discourages commercial banks in borrowing from central bank as it will increase the cost of borrowing of commercial bank.
 - > It forces the commercial banks to increase their lending rates, which discourages borrowers from taking loans, which discourages investment.
 - > Again high rate of interest induces households to increase their savings by restricting expenditure on consumption.
 - > Thus, expenditure on investment and consumption is reduced, which will control the excess demand.
 - In a situation of deficient demand leading to deflation,
 - > Central bank decreases bank rate that encourages commercial banks in borrowing from central bank as it will decrease the cost of borrowing of commercial bank.
 - > Decrease in bank rate makes commercial bank to decrease their lending rates, which encourages borrowers from taking loans, which encourages investment.
 - > Again low rate of interest induces households to decrease their savings by increasing expenditure on consumption.
 - > Thus, expenditure on investment and consumption increase, which will control the deficient demand.
 - (b) Open Market Operations (OMO)
 - It consists of buying and selling of government securities and bonds in the open market by central bank.
 - In a situation of excess demand leading to inflation, central bank sells government securities and bonds to commercial bank. With the sale of these securities, the power of commercial bank of giving loans decreases, which will control excess demand.
 - In a situation of deficient demand leading to deflation, central bank purchases government securities and bonds from commercial bank. With the purchase of these securities, the power of commercial bank of giving loans increases, which will control deficient demand.
 - (c) Imposing margin requirement on secured loans
 - Business and traders get credit from commercial bank against the security of their goods. Bank never gives credit equal to the full value of the security. It always pays less value than the security.
 - So, the difference between the value of security and value of loan is called marginal requirement.
 - In a situation of excess demand leading to inflation, central bank raises marginal

requirements. This

discourages borrowing because it makes people get less credit against their securities.

- In a situation of deficient demand leading to deflation, central bank decreases marginal requirements. This encourages borrowing because it makes people get more credit against their securities.

(d) Moral Suasion

- Moral suasion implies persuasion, request, informal suggestion, advice and appeal by the central banks to commercial banks to cooperate with general monetary policy of the central bank.

- In a situation of excess demand leading to inflation, it appeals for credit contraction.

- In a situation of deficient demand leading to deflation, it appeals for credit expansion.

4. Do you consider a commercial bank 'Creator of money' in the economy?

[6 Marks] Or

Explain the process of money creation/deposit creation/credit creation by the commercial banking system. [CBSE 2010, IOC, 11] Or

Giving a numerical example, explain the process of money creation by the commercial banks.

[Sample Paper 2013], Or

How do commercial banks create deposits? Explain. [CBSE 2013 (Set II)] Or

Explain the credit creation role of commercial banks with the help of a numerical example.

Or

Explain briefly the working of money multiplier. [AT 2013, C]

Ans: Yes, commercial bank acts as a 'Creator of money' in the economy. It can be explained with the help of Credit creation process:

1. Let us assume that the entire commercial banking system is one unit. Let us call this one unit simply "banks". Let us also assume that all receipts and payments in the economy are routed through the banks. One who makes payment does it by writing cheque. The one who receives payment deposits the same in his deposit account.
2. Suppose initially people deposit Rs 1000. The banks use this money for giving loans. But the banks cannot use the whole of deposit for this purpose. It is legally compulsory for the banks to keep a certain minimum fraction of these deposits as cash. The fraction is called the Legal Reserve Ratio (LRR). The LRR is fixed by the Central Bank.
3. Let us now explain the process, suppose the initial deposits in banks is Rs 1000 and the LRR is 10 percent. Further, suppose that banks keep only the minimum required, i.e., Rs 100 as cash reserve, banks are now free to lend the remainder Rs 900. Suppose they lend Rs 900. What banks do to open deposit accounts in the names of the borrowers who are free to withdraw the amount whenever they like. Suppose they withdraw the whole of amount for making payments.
4. Now, since all the transactions are routed through the banks, the money spent by the borrowers comes back into the banks into the deposit accounts of those who have received this payment. This increases demand deposit in banks by Rs 900. It is 90 per cent of the initial deposit. These deposits of Rs 900 have resulted on account of loans given by the banks. In this sense the banks are responsible for money creation. With this round increase in total deposits is now Rs 1900 (=1000 + 900).
5. When banks receive new deposit of ?900, they keep 10 per cent of it as cash reserves and use the remaining Rs 810 for giving loans. The borrowers use these loans for making payments. The money comes back into the accounts of those who have received the payments. Bank deposits again rise, but by a smaller amount of Rs 810. It is 90 per cent of the last deposit creation. The total deposits now increase to Rs 2710 (=1000 + 900 + 810). The process does not end and continues till total deposit

creation comes to ? 10000, ten times the initial deposit as shown in the table below.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

5. What role of RBI is known as 'Lender of last Resort'? [3 Marks]

Ans:

1. As banker to the banks, the central bank acts as the lender of the last resort.
2. In other words, in case the commercial banks fail to meet their financial requirements from other sources, they can, as a last resort, approach to the central bank for loans and advances.
3. The central bank assists such banks through discounting of approved securities and bills of exchange.

MORE QUESTIONS SOLVED

I. VERY SHORT ANSWER TYPE QUESTIONS (1 Mark)

1. Define commercial bank.

Ans: Commercial bank is a financial institution which performs the functions of accepting deposits from the public and making loans and investments, with the motive of earning profit.

2. Define money multiplier/credit multiplier/deposit multiplier.

Ans: When the primary cash deposit in the banking system leads to multiple expansion in the total deposits, it is known as money multiplier or credit multiplier.

3. Define central bank. [CBSE 2008, 09; A 08]

Ans: The central bank is the apex institution of a country's monetary system. The design and the control of the country's monetary policy is its main responsibility. India's central bank is the Reserve Bank of India.

4. Define bank rate. [CBSE 2009]

Ans: It is the rate of interest at which central bank lends to commercial banks without any collateral (security for purpose of loan).

5. What will be the effect of a rise in bank rate on the money supply? [CBSE Sample Paper 2008]

Ans: Money supply will reduce.

6. Define open market operations.

Ans: It consists of buying and selling of government securities and bonds in the open market by central bank.

7. What is meant by cash reserve ratio? [CBSE 2011, CBSE Sample Paper 2008, 2013]

Ans: Cash Reserve Ratio refers to the minimum percentage of a bank's total deposits, which it is required to keep with the central bank.

8. What is meant by statutory liquidity ratio? [CBSE Sample Paper 2010]

Ans: It refers to minimum percentage of net total demand and time liabilities, which commercial banks are required to maintain with themselves.

II. MULTIPLE CHOICE QUESTIONS (1 Mark)

1. Which one of the following institutions is not a bank?

- (a) HDFC (b) LIC
- (c) UTI (d) All of them

Ans:(d)

2. Quantitative instrument of RBI can be:

- (a) Bank Rate policy
- (b) Cash Reserve Ratio
- (c) Statutory Liquidity Ratio
- (d) All of them

Ans: (d)

3. refers to that portion of total deposits of a commercial bank which it has to keep with RBI in the form of cash reserves.

- (a) CRR (b) SLR .
- (c) Bank Rate (d) Repo Rate

Ans: (a)

4. refers to that portion of total deposits of a commercial bank which it has to keep with itself in the form of liquid assets.

- (a) CRR (b) SLR
- (c) Bank Rate (d) Repo Rate

Ans: (b)

5. In order to control credit in the country, the RBI may

- (a) buy securities in the open market
- (b) sell securities in the open market
- (c) reduce CRR
- (d) reduce bank rate

Ans: (b)

6. In order to encourage investment in the country, the RBI may

- (a) reduce CRR. (b) increase CRR.
- (c) sell securities in the open market.
- (d) increase bank rate.

Ans: (a)

7. In order to discourage investment in the economy, the RBI may

- (a) Increase bank rate
- (b) decrease bank rate
- (c) buy securities in the open market

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(d) decrease CRR

Ans: (a)

8. The effect of increase in CRR will be reduced or nullified if

(a) bank rate is reduced

(b) securities are sold in the open market

(c) SLR is increased

(d) people do not borrow from non-banking institutions

Ans: (a)

9. In order to control credit

(a) CRR should be increased and bank rate should be decreased

(b) CRR should be reduced and bank rate should be reduced

(c) CRR should be increased and bank rate should be increased

(d) CRR should be reduced and bank rate should be increased

Ans: (c)

10. controls affect indiscriminately all sectors of the economy.

(a) Selective credit

(b) Quantitative

(c) Margin requirements

(d) None of the above

Ans: (b)

11. During depression, it is advisable to

(a) lower bank rate and purchase securities in the market

(b) increase bank rate and purchase securities in the open market

(c) decrease bank rate and sell securities in the open market.

(d) increase bank rate and sell securities in the open market

Ans: (a)

12. The 'lender of last resort' means

(a) the government coming to the rescue of poor farmers.

(b) Central Bank coming to the rescue of other banks in times of financial crisis.

(c) commercial banks coming to the rescue of small industrial units.

(d) None of them.

Ans: (b)

13. Who is called the 'bank of issue'?

(a) RBI (b) SBI

(c) IDBI (d) ICICI

Ans: (a)

14. Who is the fiscal agent and adviser to government in monetary and financial matters in India?

(a) SBI (b) IDBI

(c) ICICI (d) RBI

Ans: (d)

15. Who is the custodian of national reserves of international currency?

(a) SBI (b) IDBI

(c) RBI (d) ICICI

Ans: (c)

16. If an economy is to control recession like most of the Euro-Zone nations, which of the following can be appropriate:[CBSE Sample Paper 2016]

(a) Reducing Repo Rate

(b) Reducing CRR

- (c) Both (i) and (ii)
(d) None of (i) and (ii)

Ans: (c)

III. SHORT ANSWER TYPE QUESTIONS[3-4 Marks]

1. Explain issue of currency function of Central Bank.

[CBSE 2004C, 06; AI 11] Or

Explain the “Bank of Issue Function” of the central Bank.[CBSE, AI 2015]

Ans:

1. The central bank has the sole monopoly to issue currency notes. Commercial banks cannot issue currency notes. Currency notes issued by the central bank are the legal tender money.
2. Legal tender money is one, which every individual is bound to accept by law in exchange for goods and services and in the discharge of debts.
3. Central bank has an issue department, which is solely responsible for the issue of notes.
4. However, the monopoly of central bank to issue the currency notes may be partial in certain countries.
5. For example, in India, one rupee notes and all coins are issued by the government and all other notes are issued by the Reserve Bank of India.

2. Explain banker to the government function of a Central Bank.[CBSE 2013, 06C; AI 08; 10]

Or

Explain “Government’s Bank” function of Central Bank.[CBSE 2015]

Ans: As a banker to the government, the central bank performs same functions as performed by the commercial banks to their customers.

1. It receives deposits from the government and collects cheques and drafts deposited in the government account.
2. It provides cash to the government as resumed for payment of salaries and wages to their staff and other cash disbursements.
3. It makes payments on behalf of the government.
4. It also advances short term loans to the government.
5. It supplies foreign exchange to the government for repaying external debt or making other payments.

3. Explain the “banker’s bank ’ function of a central bank.[AI 2015, 2007, 11, CBSE 13, AI]

Ans: Central bank acts as the banker to the banks in three ways :

1. custodian of the cash reserves of the commercial banks;
 2. as the lender of the last resort; and
 3. as clearing agent.
1. As a custodian of the cash reserves of the commercial banks, the central bank maintains the cash reserves of the commercial banks. Every commercial bank has to keep a certain percent of its cash reserves with the central bank by law.
 2. As Lender of the Last Resort.
(a) As banker to the banks, the central bank acts as the lender of the last resort.
(b) In other words, in case the commercial banks fail to meet their financial requirements from other sources, they can, as a last resort, approach to the central bank for loans and advances.
 3. The central bank assists such banks through discounting of approved securities and bills of exchange.
(c) As Clearing Agent
(i) As the custodian of the cash reserves of the commercial banks, the central bank acts as the clearing house for these banks.
(ii) Since all banks have their accounts with the central bank, the central bank can easily settle

the claims of various banks against each other simply by book entries of transfers from and to their accounts.

(iii) This method of settling accounts is called Clearing House Function of the central bank.

4. How does central bank control availability of credit by open market operations?[CBSE 2005, 06C, 11C; AT 04, 10]

Ans:

1. Open Market Operation consists of buying and selling of government securities and bonds in the open market by central bank.
2. To control availability of credit, central bank sells government securities and bonds to commercial bank.
3. With the sale of these securities, the power of commercial banks of giving loans decreases.

5. What is Legal Reserve Ratio? Explain its components. [AI 2013, C (Set 1)]

Ans:

1. **Legal Reserve Ratio:** It is the minimum ratio of deposits legally required to be kept by the commercial banks with themselves and with the central bank.
2. **It's components are:**
 - (a) **Cash Reserve Ratio:** It refers to the minimum percentage of a bank's total deposits, which it is required to keep with the central bank.
 - (b) **Statutory Liquidity Ratio:** It refers to minimum percentage of net total demand and time liabilities, which commercial banks are required to maintain with themselves.

6. Differentiate between central bank and commercial bank.

Or

State any three points of distinction between central bank and commercial bank.[CBSE 2009]

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

IV.TRUE OR FALSE

Giving reasons, state whether the following statements are true or false.

1. Increase in statutory liquidity ratio adversely affects the capacity of commercial banks to create credit.

Ans: True. An increase in statutory liquidity ratio reduces the excess reserves of commercial banks and limits their credit creating power.

2. Sale of securities in the open market by the commercial banks reduces their crediting power.

Ans: False. Purchase of securities decreases the reserves of commercial banks, which reduces their crediting power, not the sale of securities in the open market.

3. Cash reserve ratio and statutory liquidity ratio are fixed by the central bank.

Ans: True. They are fixed by central bank under quantitative instruments of credit control.

4. Under marginal requirement, the Reserve Bank of India gives directions to other banks to channelise credit to priority sectors.

Ans: False. It happens under selective credit controls.

5. There is an inverse relationship between legal reserve ratio (LRR) and value of money multiplier.

Ans: True. Money multiplier is inversely related to LRR as Money Multiplier

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

6. To increase the money supply in the economy central bank increases the margin requirements.

Ans: False. Rise in margin requirements discourages the borrowing capacity of public which decreases the money supply in the economy.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

V. LONG ANSWER-TYPE QUESTION(6 Marks)

1. (i) What is meant by Cash Reserve Ratio? How does it increase the money Supply in the economy? (ii) What is meant by Open Market Operation? How does it reduce the money supply in the economy?[CBSE Sample Paper 2014][(3 + 3)]

Ans:

1. Cash Reserve Ratio:

(a) It refers to the minimum percentage of a bank's total deposits, which it is required to keep with the central bank. Commercial banks have to keep with the central bank a certain percentage of their deposits in the form of cash reserves as a matter of law.

(b) For example, if the minimum reserve ratio is 10% and total deposits of a certain bank is ₹100 crore, it will have to keep ₹10 crore with the central bank.

(c) To increase Money supply in an economy, cash reserve ratio (CRR) falls to 5 per cent, the bank will have to keep ₹5 crore with the central bank, which will increase the cash resources of commercial bank and increasing credit availability in the economy, which will increase the money supply in an economy.

2. Open Market Operation:

(a) It consists of buying and selling of government securities and bonds in the open market by central bank.

(b) To reduce Money Supply in an economy, central bank sells government securities and bonds to commercial bank. With the sale of these securities, the power of commercial bank of giving loans decreases, which will reduce the money supply in an economy.

VI. HIGH ORDER THINKING SKILLS

1. Differentiate between quantitative and qualitative instruments of credit control. [3]

Marks]

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

2. Calculate the value of money multiplier and total deposit created if initial deposit is of Rs 1,000 crore and LRR is 20%. [3 Marks]

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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3. If the total deposits created by commercial banks is Rs 10,000 crore and legal reserve requirements is 10%, calculate the amount of initial deposits. [3 Marks]

Ans:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

VII. VALUE BASED QUESTIONS

1. In the situation of inflation credit creation by commercial bank is beneficial for the bank but it explain its negative impact on economy.[1 Mark]

Ans: Money creation by commercial bank in the condition of rising prices increases money supply. It creates the situation of excess demand and consequently again increases the price level.

Value: Analytic.

2. Suppose all the customers of a commercial bank demand for their deposits at the same time then how does central bank help to commercial bank in this situation. [3 Marks]

Ans:

1. As banker to the banks, the central bank acts as the lender of the last resort.
2. In other words, in case the commercial banks fail to meet their financial requirements from other sources, they can, as a last resort, approach to the central bank for loans and advances.
3. The central bank assists such banks through discounting of approved securities and bills of exchange. Value: Analytic.

VIII. APPLICATION BASED QUESTIONS

1. Why are the banks required to keep only a fraction of deposits as cash reserves? [3 Marks]

Ans: It is because of the following two reasons:

1. The banking experience has revealed that not all depositors approach the banks for withdrawal of money at the same time and also that normally they withdraw a fraction of deposits.
2. There is a constant flow of new deposits into the banks. Therefore to meet the daily demand for withdrawal of cash, it is sufficient for banks to keep only a fraction of deposits as a cash reserve.

2. Currency is issued by the central bank, yet we say that commercial banks create money. Explain. How is this money creation by commercial banks likely to affect the national income? Explain.

[CBSE AI 2015][4 Marks] Or

Government of India recently launched 'Jan-Dhan Yojna' aimed at every household in the country to have at least one bank account. Explain how deposits made under the plan are going to affect national income of the country.

[CBSE 2015][4 Marks]

Ans: Yes, central bank has a sole monopoly power to issue currency, but commercial bank create money by credit creation. It is explained as under: [CBSE AI 2015]

Or

Due to launch of “Jan- Dhan Yojna” people start depositing their money in banks, which will increase the initial deposits with the commercial bank, which will increase the money creation in an economy by credit creation. It is explain as under:[CBSE Delhi 2015]

1. Let us assume that the entire commercial banking system is one unit. Let us call this one unit simply “banks’. Let us also assume that all receipts and payments in the economy are routed through the banks. One who makes payment does it by writing cheque. The one who receives payment deposits the same in his deposit account.
2. Suppose initially people deposit ₹1000. The banks use this money for giving loans. But the banks cannot use the whole of deposit for this purpose. It is legally compulsory for the banks to keep a certain minimum fraction of these deposits as cash. The fraction is called the Legal Reserve Ratio (LRR). The LRR is fixed by the Central Bank.
3. Let us now explain the process, suppose the initial deposits in banks is ₹1000 and the LRR is 10 percent. Further, suppose that banks keep only the minimum required, i.e., ₹100 as cash reserve, banks are now free to lend the remainder ₹900. Suppose they lend ₹900. What banks do to open deposit accounts in the names of the borrowers who are free to withdraw the amount whenever they like. Suppose they withdraw the whole of amount for making payments.
4. Now, since all the transactions are routed through the banks, the money spent by the borrowers comes back into the banks into the deposit accounts of those who have received this payment. This increases demand deposit in banks by Rs 900. It is 90 per cent of the initial deposit. These deposits of Rs 900 have resulted on account of loans given by the banks. In this sense the banks are responsible for money creation. With this round increase in total deposits is now Rs 1900 (=1000 + 900).
5. When banks receive new deposit of Rs 900, they keep 10 per cent of it as cash reserves and use the remaining ₹810 for giving loans. The borrowers use these loans for making payments. The money comes back into the accounts of those who have received the payments. Bank deposits again rise, but by a smaller amount of Rs 810. It is 90 per cent of the last deposit creation. The total deposits now increase to Rs 2710 (= 1000 + 900 + 810). The process goes on till the total deposit creation comes to Rs 10000, ten times the initial deposit as shown in the table below.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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So, with initial deposit of 1000, money creation or money supply increase by 10,000, which will increase the contribution in the flow of goods and services, which will thereby increase the national income. [CBSE (AI) 2015]

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Question 1. What is marginal propensity to consume? How is it related to marginal propensity to save?[3-4 Marks]

Answer: (i) The ratio of change in consumption (C) to change in income (Y) is known as marginal propensity to consume. It indicates the proportion of additional income that is being spent on consumption.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

The sum of MPC and MPS is equal to one. It can be proved as under: We know: $\Delta Y = \Delta C + \Delta S$

Dividing both sides by ΔY , we get, $\frac{\Delta Y}{\Delta Y} = \frac{\Delta C}{\Delta Y} + \frac{\Delta S}{\Delta Y}$ or $1 = MPC + MPS$

[$\frac{\Delta Y}{\Delta Y} = 1$; $\frac{\Delta C}{\Delta Y} = MPC$ $\frac{\Delta S}{\Delta Y} = MPS$]

$MPC + MPS = 1$ because total increment in income is either used for consumption or for saving.

Question 2. What do you understand by 'para-metric shift of a line'? How does a line shift when its (i) slope increases and (ii) its intercept increases?

Answer: (i)

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

when b increases from 0.5 to 0.75, then consumption curve (which is a straight line) pivots upwards. This is called a parametric shift of a graph. It is shown in figure.

(ii) When C increases: It is the autonomous part of the consumption function. It graphically gives the intercept of the consumption curve. If increases from 2 to 5, there will be parallel upward shift in the consumption curves. It is shown in figure given.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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Thus, when slope changes, there is parametric shift in the curve. When intercept changes, there is parallel shift in the curve.

MORE-QUESTIONS SOLVED

I. Very Short Answer Type Questions

Question 1. What is Aggregate demand in Macroeconomics? [CBSE 2005C, 06, 09C, 10; AI 2015]

Answer: It is aggregate expenditure on ex-ante (planned) consumption and ex-ante (planned) investment that all sectors of the economy are willing to incur at each income level.

Question 2. What is Aggregate Supply in Macroeconomics? [CBSE 2015, 1995C, 2000; AI 1999]

Answer: Aggregate supply is the total amount of money value of goods and services, (which is paid to the factor of production against their factor services) that all the producers are willing to supply in an economy.

Question 3. What is consumption function? [CBSE 2008]

Answer: Consumption function expresses functional relationship between aggregate consumption and national income.

Question 4. Can the value of APC be less than zero?

Answer: No, because even at the zero level of income, we will consume something i.e., autonomous consumption.

Question 5. Why can value of MPC be not greater than one? [AI 1998]

Answer: It is so because Keynes' psychological law of consumption states that when income increases, consumption also increases but at a lesser rate. So, increase in consumption is always less than increase in income, i.e., $MPC = \Delta C / \Delta Y$ is always less than one.

Question 6. Can the value of average propensity to save be negative? If yes, when? [CBSE Foreign 2009]

Answer: Yes, the value of average propensity to save can be negative when consumption is more than national income, i.e., before the break-even point.

Question 7. What can be the maximum value of marginal propensity to save?

Answer: The maximum value of marginal propensity to save is 1. It is only possible when $MPC = 0$, i.e., the entire additional income is saved.

Question 8. What is the relationship between APC and APS?

Answer: The sum of APC and APS is equal to one, i.e., $APC + APS = 1$.

Question 9. What is the relationship between marginal propensity to save and marginal propensity to consume? [CBSE Sample Paper 2010]

Answer: The sum total of MPC and MPS is equal to one, i.e., $MPC + MPS = 1$.

Question 10. Give the meaning of autonomous consumption. [CBSE 2009]

Answer: It refers to minimum level of consumption (i.e., C), which is needed for survival, i.e., consumption at zero level of national income.

Question 11. Let the consumption be $C = 50 + 0.75 Y$, then calculate saving function?

Answer: As we know that

$$S = Y - C = Y - (50 + 0.75 Y)$$

$$= Y - 50 - 0.75 Y$$

$$S = -50 + Y(1 - 0.75) = -50 + 0.25 Y$$

II. Multiple Choice Questions (1 Mark)

Question 1. If APS is 0.9, how much will be the APC?

(a) 0.2 (b) 0.5

(c) 1 (d) 0.1

Answer: (d)

Question 2. If MPC is 0.6, what will be the MPS?

(a) 0.2 (b) 0.4

(c) 0.9 (d) 0.5

Answer: (b)

Question 3. If disposable income is ₹1000 and consumption expenditure is ₹750, the value of average propensity to save will be-----.

(a) 0.25 (b) 0.9

(c) 0.85 (d) 0.2

Answer: (a)

Question 4. If the saving function is $S = -50 + 0.2Y$, then the MPC is

(a) 0.45 (b) 0.8

(c) 0.65 (d) 0.25

Answer: (b)

Question 5. There is parametric shift in the consumption line when -----.

(a) slope changes

(b) intercept changes

(c) APC changes

(d) none of them

Answer: (a)

Question 6. Guideline is the alternative name of —————.

(a) aggregate demand

(b) aggregate supply

(c) MPC (d) APS

Answer: (b)

Question 7. What is the value of MPC when $MPS = 0$?

(a) 0 (b) 4

(c) 3 (d) 1

Answer: (d)

Question 8. If MPS is one, how much is MPC?

(a) 3 (b) 2

(c) 0 (d) 1

Answer: (c)

III. Short Answer Type Questions [3-4 Marks]

Question 1. Explain the components of aggregate demand.

Or

State components of AD. Describe any one. [CBSE 1995, 96, 96C, 97C, 2005C, 06, 09]

Answer: The components of aggregate demand are:

1. Private (or Household) consumption demand

(a) The total expenditure incurred by all the households of the country on their personal consumption is known as private consumption expenditure.

(b) Consumption demand depends mainly on disposable income and propensity to consume.

2. Private investment demand

(a) Private investment demand refers to the demand for capital goods by private investors.

(b) It is addition to the existing stock of real capital assets such as machines, tools, factory-building etc.

(c) Investment demand depends upon marginal efficiency of capital (Marginal efficiency of investment) and interest rate.

(d) Investment is of two types, Autonomous Investment and Induced investment, but in Keynes theory investment assumed to be Autonomous.

3. Government demand for goods and services

(a) In a modern economy, the government is an important buyer of goods and services.

(b) The government demand may be on account of public needs for roads, schools, hospitals, power, irrigation etc, for the maintenance of law and order and for defence.

4. Demand for net export ($X - M$)

(a) Net export represents foreign demand for goods and services produced by an economy.

(b) When exports exceed imports, net exports is positive and when imports exceed, net exports is negative.

(c) Exports and imports of a country are influenced by a number of factors such as foreign trade policy, exchange- rate, prices and quality of goods etc.

Thus, aggregate demand consists of these four types of demand.

$AD = C + I + G + (X - M)$

Question 2. Explain the distinction between 'autonomous investment' and 'induced investment'. [CBSE 2013 (C)]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 3. Briefly state the concept of consumption function. Explain with schedule and diagram. [CBSE 2008; AI 08, 09]

Answer: (i) Consumption function expresses functional relationship between aggregate consumption and national income. Thus, consumption (C) is a function of income (Y).

$$C = F(Y)$$

Where,

C = Consumption

F = Function

Y = Disposable income

(ii) It can be explained with the help of the following schedule and diagram:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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The above schedule and diagram shows Keynes' Psychological law of Consumption, which states that as income increases consumption expenditure also increases but increase in consumption is smaller than the increase in income.

Question 4. With the help of consumption schedule or curve bring out meaning of break-even point.

Answer: Break-even point refers to that point in the level of income at which consumption is just equal to income. In other words, whole of income is spent on consumption and there is no saving.

Below this level of income, consumption is greater than income but above this level, income is greater than consumption.

It can be explained with the help of following schedule and diagram:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

In the above imaginary house hole schedule of consumption and saving, at annual income level of Rs 60,000, consumption is Rs 60,000 and in consequence there is no saving. This is break-even point.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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In the above diagram, when Consumption (C) = National Income(Y), savings are zero. This is known as break-even point. This is shown by point E in the diagram. Thus break even point indicates a point where consumption becomes equal to income or consumption curve cuts the income curve.

Question 5. What is APC? How is it calculated?[AT 1991; CBSE 92 C, 2004]

Answer: The ratio of aggregate consumption expenditure to aggregate income is known as average propensity to consume. It indicates the percentage (or ratio) of income which is being spent on consumption. It is worked out by dividing total consumption expenditure (C) by total income (Y).

$$APC = C/Y$$

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 6. Distinguish between APS and MPS. The value of which of these two can be negative and when? [CBSE 2004, 2011]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

APS can be negative, when at low level of income consumption exceeds income, savings are negative which make the APS negative. It can be explained with the help of the following schedule:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 7. Differentiate between APC and APS and tell which of them is negative.
Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

APS can be negative. When at low level of income consumption exceeds income, savings are negative

and make the APS negative. It can be explained with the help of the following schedule.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 8. Differentiate between APC and MPC.

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 9. Explain saving function with the help of schedule and diagram. [AI 2008]

Answer: (i) Propensity to save (or saving function) shows the functional relationship between aggregate savings and income. $S=f(Y)$

In other words, the part of income which is not spent on current consumption is known as saving. By

deducting consumption expenditure (C) from income (Y), we get saving (S). $S = Y - C$

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

IV. True Or False

Giving reasons, state whether the following statements are true or false:

Question 1. Average propensity to save is always greater than zero. [CBSE (D) 2010]

Answer: False. Because at very low level of income, when consumption exceeds income, then saving becomes negative and $APS < 0$. It can be explained with the help of the following schedule:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 2. Value of average propensity to save can never be less than zero. [CBSE AT 2010]

Answer: False. The value of APS can be less than zero (i.e., negative). When consumption expenditure (C) becomes greater than income then the volume of savings becomes negative. Hence APS will be negative, (i.e., less than zero). This is shown as;

Let $C = 1500$ and $Y = 1,000$.

We know, $S = Y - C = 1,000 - 1500 = -500$

$APS = S/Y = -500/1000 = (-)0.5$

Thus, the value of APS can be less than zero (i.e. negative).

Question 3. When the value of average propensity to save is negative, the value of marginal propensity to save will also be negative. [AI 2010]

Answer: False. Value of APS has no relationship with MPS. APS is closely related with APC, i.e., $APS + APC = 1$. When APC is greater than unity (as in case of lower level of income), the value of APS is negative.

Question 4. The value of marginal propensity to save can never be negative. [CBSE (D) 2010]

Answer: True. MPS can never be less than zero as change in savings can never be negative, i.e., change in consumption can never be more than the change in income.

Question 5. The value of average propensity to save can never be greater than 1.[CBSE (Fj 2010)]

Answer: True because Saving can never be greater than Income.

Question 6. Sum of average propensity to consume and marginal propensity to consume is always equal to 1.[CBSE AI 2010]

Answer: False. The value of APC has no relationship with MPC. Either $APC + APS = 1$ or $MPC + MPS = 1$

Question 7. If income is Rs 10,000 crore and consumption is Rs 5,000 crore, APC would be 0.5.

Answer: True. As, $APC = C/Y = 5000/10000 = 0.5$

Note: As per CBSE guidelines, no marks will be given if reason to the answer is not explained.

V.Long Answer Type Questions (6 Marks)

Question 1. Draw a straight line consumption curve. From it derive the saving curve. Explain the process of derivation on the diagram, show:

(i) The income level at which $APC = 1$.

(ii) The income level at which APS is negative. [CBSE Sample Paper 2014] Or

Outline the steps taken in deriving saving curve from the consumption curve. Use diagram. [CBSE 2012] Or

Draw on a diagram a straight line Consumption curve for an economy. From it derive the saving curve, explaining the method of derivation. Show a point on the consumption curve at which $APS = 0$?

Answer: To explain the below figure we define the following two terms.

(i) Consumption function: Consumption function expresses functional relationship between aggregate consumption and national income. It can be expressed as: consumption is equal to national income, which is known as break-even point. At point P, $APC = 1$ because consumption is equal to income at this point.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

(iv) Corresponding to point P, we derive the point

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

in figure B where Saving is equal to zero. At point $APS = 0$. After point P in figure A, national income is greater than consumption, i.e., positive saving,

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

which has shown in figure B, after point , where savings are positive.

(v) Before point P in figure A consumption is greater than income, i.e., negative saving or dis-saving,

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

which has been shown in figure B before point where savings are negative.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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Question 2. Draw on a diagram a straight line savings curve for an economy. From it derive the consumption curve, explaining the method of derivation. Show a point on the consumption curve at which $APC = 1$? [CBSE 2006]

Answer: To explain the above figure we define the following two terms.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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(iii) Figure B is derived from A. In Figure A at point P saving = 0. Corresponding to point P, we derive the point P: in figure B where income = consumption. Point Pj is known as to be break-even point and at this point only APC = 1.

(iv) After point P in figure A savings are positive, which has been shown in figure B, after point Pt where Income is greater than consumption, i.e., positive saving.

(v) Before point P in figure A savings are negative which has shown in figure B before point Pi; where consumption is greater than income, i.e., negative saving or dis-saving.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

VI. Higher Order Thinking Skills

Question 1. Why APC falls with the increase in income? [1 Mark]

Ans: APC falls continuously with the increase in income because the proportion of income spent on consumption keeps on decreasing.

Question 2. Can APC be zero? [1 Mark]

Answer: APC can be zero only when consumption becomes zero. However, consumption is never zero at any level of income. Even at zero level of national income, there is autonomous consumption (C).

Question 3. What can be the maximum value of marginal propensity to save? [1 Mark]

Answer: The maximum value of marginal propensity to save is 1. It is possible only when $MPC = 0$, i.e., the entire additional income is saved.

Question 4. MPC of the poor is more than that of the rich. [1 Mark]

Answer: True. It happens because the poor spend a greater percentage of their increased income on consumption as most of their basic needs remain unsatisfied. As against it, the rich people spend a smaller proportion as their basic needs are already satisfied.

Question 5. In Keynes theory, MPC fall with an increase in income. [1 Mark]

Ans: False. Because Keynes assumed MPC remains constant. So, with the increase in income, MPC remains constant.

Question 6. What is a guideline? [3 Marks]

Answer: The aggregate supply (AS) curve which is a 45° positively sloping line from the origin. -It is also called a guideline. Every point on AS curve is equidistant from the horizontal axis and the vertical axis implying that total income is equal to total expenditure or spending, i.e., $C + S$. If whole of national income is spent on consumption of goods and services, $S = 0$. It is called break-even point.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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Question 7. Complete the following table:[3-4 Marks]

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

VII. Value Based Question

Question 1. Why do the consumption expenditure of involuntary unemployed worker is not zero, even at zero level of income?[1 Mark]

Answer: A worker has to incur some expenditure to fulfill his basic needs even at zero level of income.

Value: Analytic.

VIII. Applications Based Questions

Question 1. Given below is the consumption function of an economy: $C = 100 + 0.5Y$. With the help of a numerical example show that in this economy as income increases APC will decrease.[CBSE Sample Paper 2010][6 Marks]

Answer:

Given consumption function: $C = 100 + 0.5Y$.

To show that APC decreases with the increase in income, consider the following hypothetical schedule:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

As seen in the given schedule when the income increases from Rs 100 crore to Rs 200 crore and then to Rs 300 crore and so on, APC decreases from 1.5 to 1 and then to 0.83 and keeps on decreasing with the increase in income. Therefore, with an increase in income, APC decreases.

Question 2. What do you understand by 'parametric shift of a line? How does a line shift when its (i) slope decreases and (ii) its intercept decreases? [3-4 Marks]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 3. “Economists are generally concerned about the rising Marginal Propensity to Save (MPS) in an economy”. Explain why?[CBSE Sample Paper 2016] [3-4 Marks]

Answer:

1. As we know, the sum of MPC and MPS is unity. Any Increase in Marginal Propensity to save (MPS) would leads to decrease in Marginal Propensity to consume (MPC).
2. It means, with the increase in Income, lesser and lesser proportion of Income is spend on consumption.
3. As, consumption is an important component of Aggregate Demand. If consumption falls, Aggregate Demand/Expenditure Fall, which will further leads to fall in Equilibrium level of Income in the economy.

Question 4. Derive a straight line saving curve using the following consumption function:

$C = 200 + 0.6 Y$. Presuming the income levels to be Rs 100, Rs 200 and Rs 300 crores. Also calculate that level of income where consumption is equal to income.[CBSE Sample Paper 2016] [6 Marks]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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1. Figure B is derived from figure A. In Figure A at point P, consumption is equal to national income, which is known as break-even point. At point P, $APC = 1$ because consumption is equal to income at this point.
2. Corresponding to point P, we derive the point Pj in figure B where Saving is equal to zero. At point P: $APS = 0$. After point P in figure A, national income is greater than consumption, i.e., positive saving, which has shown in figure B, after point P1(where savings are positive).
3. Before point P in figure A consumption is greater than income, i.e., negative saving or dis-saving, which has been shown in figure B before point Pi; where savings are negative.

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Question 1. Measure the level of ex-ante aggregate demand when autonomous investment and consumption expenditure (A) is Rs 50 crores, and MPS is 0.2 and level of income (Y) is Rs 4000 crores. State whether the economy is in equilibrium or not (cite reasons). [3-4 Marks]

Answer: As given in the examination problem, Equilibrium Income (Y) = Rs 4000 crore
 Autonomous Investment + Autonomous

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Consumption = Rs 50 crore MPS = 0.2

So, MPC(b) = 1 - 0.2 = 0.8

(MPC = 1 - MPS)

AD = C + I

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

AD = + bY + I

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

= + bY

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

$$= 50 + 0.8Y$$

As we know, the equilibrium level of national income in two-sector model is determined where,
AS = AD

$$Y = 50 + 0.8Y$$

$$4000 = 50 + 0.8(4000)$$

$$4000 = 50 + 3200$$

$$4000 = 3250$$

Hence, the economy is not in equilibrium.

Question 2. Explain 'Paradox of Thrift'. [3-4 Marks]

Answer:

- The term thrift means savings and the paradox of thrift shows how an attempt by the economy as a whole to save more out of its current income will ultimately result in lower savings for the economy.
- If all the people in the economy make an effort to save more, then the total savings of the community will not increase, on the contrary they will decrease. This is called the paradox of thrift.
- Reasons for "Paradox of thrift" to operate:
 - As we know that one person's expenditure is another person's income.
 - If individual 'A' decides to save more by reducing his consumption expenditure, the income of individual 'B' will be less and individual 'B' in turn will spend less.
 - Thus, if all individuals in the economy decide to save more, the income received by each individual will be less and overall income will fall and also lower will be the total savings.
- Diagram Representation:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

In the above figure, we have induced investment function which makes the investment curve upward positively sloping. With the increase in savings, not only the equilibrium income falls, but also savings decline.

Question 3. What is Effective Demand? How will you derive the autonomous expenditure multiplier when price of final goods and the rate of interest are given?[6 Marks]

Answer:

1. The level at which the economy is in equilibrium, i.e., where aggregate demand = aggregate supply, is called effective demand.
2. Under fixed price model, the value of planned (ex-ante) aggregate demand for final goods AD is equal to ex-ante consumption plus ex-ante investment expenditure.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

AD = C + I =

+ bY

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

+

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

=

+ bY

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

= 2 of all autonomous variable,

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

i.e.,

3. As we know that the equilibrium level of national income in two sector model is determined where,
 $AS = AD$

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

$Y =$

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$+bY =$

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

4. Diagrammatical representation,

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

In the above mentioned diagram, aggregate demand is measured on vertical axis and national income is measured on horizontal axis. Initially, at autonomous

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

expenditure, the equilibrium level of national income OY is determined at point E. But due to increase in autonomous expenditure

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

from

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Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

to

, the aggregate demand curve shifts upward

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

from AD to A

and at the same level of national income, i.e., OY, aggregate demand is greater than aggregate supply. Production will have to be increase to meet the excess demand. Consequently, national income will increase from OY to O

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

As, we know positive relationship exists between national income and consumption, so consumption will increase which will, increase the new

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

aggregate demand A , till we reach the new

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

equilibrium level of output i.e., O

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

at

MORE QUESTIONS SOLVED

I. Very Short Answer Type Questions (1 Mark)

Question 1. If planned savings are greater than planned investments, what will be its effect on inventories? [CBSB Sample Paper 2008]

Answer: The inventories will rise.

Question 2. What is meant by effective demand?

Answer: The level at which the economy is in equilibrium, i.e., where aggregate demand = aggregate supply, is called effective demand.

Question 3. Define the term 'multiplier'. How do we measure it?

Answer: The ratio of change in national income (

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

) due to change in investment (

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

) is known as multiplier (K).

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

(K)=

Question 4. An increase of Rs 1000 crore in investment leads to a rise of Rs 5000 crore in the national income. Calculate the value of multiplier.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Answer: Multiplier (k)=

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Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

=

=Rs 5

Question 5. If investment multiplier is 1, what will be the value of marginal propensity to consume?

Answer: Marginal propensity to consume = 0.

Question 6. If marginal propensity to save is 0.1, calculate the value of multiplier.[CBSE 2003]

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Answer: Multiplier (k) =

Question 7. If the value of marginal propensity to consume is 0.6, calculate the value of multiplier.

Answer: Multiplier K

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

=

II. Multiple Choice Questions (1 Mark)

Question 1. If in an economy investment is greater than saving, national income of the economy,

- (a) increases
- (b) decreases
- (c) remains constant
- (d) None of them

Answer: (a)

Question 2. What happens to the level of national income, when aggregate supply falls short of aggregate demand?

- (a) Increases (b) Decreases
- (c) Constant (d) None of them

Answer: (a)

Question 3. What happens to the level of national income, when aggregate supply exceeds aggregate demand?

- (a) Increases
- (b) Decreases
- (c) Remains constant
- (d) None of them

Answer: (b)

Question 4. If MPC and MPS are equal, value of multiplier is,

- (a) 2 (b) 1

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(c) 5 (d) 3
Answer: (a)

Question 5. What is the relationship between MPS and Multiplier?

- (a) Positive (b) Negative
(c) Constant (d) None of them

Answer: (b)

Question 6. What can be the minimum value of investment multiplier?

- (a) 0 (b) 1
(c) 2 (d) 5

Answer: (b)

Question 7. What can be the maximum value of investment multiplier?

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

- (a) 5 (b) 4
(c) 4 (d) 2
Answer: (b)

Question 8. If marginal propensity to save is 0.1 and increase in national income is Rs 500 crore, calculate increase in investment.

- (a) 50 cr (b) 40 cr
(c) 10 cr (d) 2 cr

Answer: (a)

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Question 9. The value of multiplier is:[CBSE Delhi 2015]

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

(a)

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

(b)

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

(c)

(d)

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Answer: (b)

Question 10. If $MPC = 1$, the value of multiplier is: [A/2015]

(a) 0 (b) 1

(c) Between 0 and 1 (d) Infinity

Answer: (d)

III. Short Answer Type Questions (3-4 Marks)

Question 1. What happens to the level of national income when aggregate demand falls short of aggregate supply?

Answer:

1. As we know that equilibrium level of national income is determined under the given condition of aggregate demand and aggregate supply, and has tendency to stick to that level i.e., where aggregate demand is equal to aggregate supply.
2. As is given in the examination problem that when aggregate demand falls short of aggregate supply, then national income will decrease as shown in the above mentioned diagram.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

3. When $AD < AS$ [At], then there would be stockpiling and producers will produce less. National income will fall and as we know positive relationship exists between national income and consumption, so consumption will fall, which will thereby decrease the aggregate demand till we reach the equilibrium.

Question 2. What happens to the level of national income when aggregate supply falls short of aggregate demand?

Answer:

- As we know that equilibrium level of national income is determined under the given condition of aggregate demand and aggregate supply, and has tendency to stick to that level i.e., where aggregate demand is equal to aggregate supply.
- As is given in the examination problem that when aggregate supply falls short of aggregate demand, then national income will increase as shown in the given diagram:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

3. When $AD > AS$ [At], then production will have to be increased to meet the excess demand. Consequently, national income will increase. As we know that positive relationship exists between national income and consumption. So consumption will increase, which will thereby increase the aggregate demand till we reach the equilibrium.

Question 3. In an economy planned saving is greater than planned investment. Explain how the economy achieves equilibrium level of national income. [CBSE Sample Paper 2014, AI 04, CBSE 04, 05, 09]

Answer:

1. It refers to the point that has come to be established under the given condition of aggregate demand and aggregate supply, and has tendency to stick to that level under this given condition. Therefore, $AD = AS$ $C + I = C + S$ $I = C + S - C = S$
2. As given in the examination problem, when planned saving is greater than planned investment, then national income will decrease as shown in the diagram.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

3. When saving > investment [at there would be stockpiling and producers will produce less. National income will fall and as we know positive relationship exists between national income and saving, then saving will start falling until it becomes equal to investment. It is here the equilibrium level of income is derived.

Question 4. If planned saving is less than planned investment, what changes will bring economy in equilibrium?

Answer:

1. It refers to the point that has come to be established under the given condition of aggregate demand and aggregate supply, and has tendency to stick to that level under this given condition. Therefore,
 $AD = AS$ $C + I = C + S$ $I = C + S - C = S$
2. As given in the examination problem, when planned saving is less than planned investment, then national income will decrease as shown in the below diagram.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

3. When, investment > saving [at], then production will have to be increased to meet the excess demand. Consequently, national income will increase leading to rise in saving until saving becomes equal to investment. It is here that equilibrium level of income is established because what the savers intend to save becomes equal to what the investors intend to invest.

Question 5. Discuss relationship between MPC and multiplier. [AI 2006]

Answer:

1. If we put maximum value of MPC, i.e., 1, we get maximum value of multiplier,

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

i.e.,

2. As against it, if we put minimum value of MPC, i.e., 0, we get the minimum value of multiplier, i.e. 1.
 3. So, positive relationship exists between MPC and multiplier. It means when MPC increases, the

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

multiplier also increases and vice-versa.

Question 6. Discuss relationship between MPS and multiplier. [CBSB 1994C, AI 1997]

Answer:

1. If we put minimum of MPS i.e. 0, we get maximum value of multiplier,

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

i.e.,

- As against it if we get maximum value of MPS, i.e., 1, if we get minimum value of multiplier, i.e., 1.
- Hence, inverse relationship exists between MPS and multiplier.
It means if MPS increases, the multiplier decreases and vice-versa.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 7. $c = 50 + 0.5Y$ is the consumption function; where C is consumption expenditure and Y is national income and investment expenditure is 72000 in an economy. Calculate:

(i) Equilibrium level of national income.

(ii) Consumption expenditure at equilibrium level of national income.[CBSE 2013 (Set III)]

Answer:

- Equilibrium level of national income (Y)

At equilibrium, $Y = C + I$

[$AD = AS = Y$ and $AD = C + I$]

Or, $Y = 50 + 0.5Y + 2,000$

[$C = 50 + 0.5Y$]

$0.5Y = 2,050$

$Y = \text{Rs } 4,100$

- Consumption expenditure at equilibrium level of national income.

Putting value of national income of 4,100 in consumption function, we get: $C = 50 + 0.5 \times$

$4,100$ $C = \text{Rs } 2,100$

(a) Equilibrium level of national income = 74,100.

(b) Consumption expenditure at equilibrium level of national income = Rs 1740

Question 8. In an economy, $C = 200 + 0.75 Y$ is the consumption function, where C is consumption expenditure and Y is national income and investment expenditure is Rs 4000 in an economy. Calculate Equilibrium level of national income and consumption expenditure.[AI 2013 (Set II)]

Answer:

- Equilibrium level of national income (Y)

At equilibrium, $Y = C + I$

[$AD = AS = Y$ and $AD = C + I$] Or, $Y = 200 + 0.75 Y + 4,000$

[$C = 200 + 0.75 Y$]

$0.25 Y = 1,200$

$Y = \text{Rs } 16,800$

- Consumption expenditure at equilibrium level of national income.

Putting value of national income of 16,800 in consumption function, we get;

$C = 200 + 0.75 \times 16,800$

$C = \text{Rs } 12,800$

- (a) Equilibrium level of national income = Rs 16,800;
 (b) Consumption expenditure at equilibrium level of national income = Rs 12,800

Question 9. From the following data about an economy, calculate (a) equilibrium level of national income and (b) total consumption expenditure at equilibrium level of national income.

(i) $C = 200 + 0.5 Y$ is the consumption function, where C is consumption expenditure and Y is national income.

(ii) Investment expenditure is 1500. [AI 2013 (Set III)]

Answer:

1. Equilibrium level of national income (Y)

At equilibrium, $Y = C + I$

[$AD = AS = Y$ and $AD = C + I$]

Or, $Y = 200 + 0.5 Y + 1500$

[$C = 200 + 0.5 Y$]

$0.5 Y = 1,700$

$Y = \text{Rs } 3400$

2. Consumption expenditure at equilibrium level of national income. Putting value of national income of 3400 in consumption function, we get; $C = 200 + 0.5 \times 3400$ $C = \text{Rs } 1900$

(a) Equilibrium level of national income = Rs 3400.

(b) Consumption expenditure at equilibrium level of national income = Rs 1900

Question 10. Calculate equilibrium national income from the following data:

[AI 2013, C (Set I)] (i) Consumption expenditure at zero income = Rs 60

(ii) Marginal propensity to consume = 0.9 (iii) Investment = Rs 100

Answer: Equilibrium level of national income (Y) At Equilibrium, $Y = C + I$

[$AD = AS = Y$ and $AD = C + I$]

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

$Y =$ + b Y + I

Or, $Y = 60 + 0.9 Y + 100$

[$C = 60 + 0.9 Y$]

$0.1 Y = 160$

$Y = \text{Rs } 1600$

Question 11. Given consumption function $C = 100 + 0.75 Y$ (where C = -consumption expenditure and Y = national income) and investment expenditure Rs 1,000, calculate:

(i) Equilibrium level of national income; (ii) Consumption expenditure at equilibrium level of national income. [CBSE 2009]

Answer:

1. Equilibrium level of national income (Y)

At equilibrium, $Y = C + I$

[$AD = AS = Y$ and $AD = C + I$] Or, $Y = 100 + 0.75 Y + 1,000$

$$[C = 100 + 0.75 Y]$$

$$0.25 Y = 1,100$$

$$Y = \text{Rs } 4,400$$

- Consumption expenditure at equilibrium level of national income. Putting value of national income of 4,400 in consumption function, we get; $C = 100 + 0.75 \times 4,400$ $C = \text{Rs } 3,400$
 - Equilibrium level of national income = Rs 4,400;
 - Consumption expenditure at equilibrium level of national income = Rs 3,400

Question 12. In an economy the consumption function is $C = 500 + 0.75 Y$, where C is consumption expenditure and Y is income. Calculate the equilibrium level of income and consumption expenditure when investment expenditure is Rs 5,000. [CBSE Foreign 2010 (I)]

Answer:

- Equilibrium level of national income (Y)

$$\text{At equilibrium, } Y = C + I$$

$$[AD = AS = Y \text{ and } AD = C + I] \text{ Or, } Y = 500 + 0.75 Y + 5,000$$

$$[C = 500 + 0.75 Y]$$

$$0.25 Y = 5,500$$

$$Y = \text{Rs } 22,000$$

- Consumption expenditure at equilibrium level of national income. Putting value of National Income of 22,000 in consumption function, we get;

$$C = 500 + 0.75 \times 22,000 \quad C = \text{Rs } 17,000$$

Equilibrium level of income = Rs 22,000; Consumption expenditure at equilibrium level of income = Rs 17,000.

Question 13. Suppose that consumption equals $C = 100 + 0.75 Y$, and investment equals $I = \text{Rs } 50$ and $Y = C + I$. Find;

(i) The equilibrium level of income

(ii) The level of consumption at equilibrium, and

(iii) The level of saving at equilibrium.

Answer:

- $Y = C + I$

$$Y = 100 + 0.75 Y + 50$$

$$Y - 0.75 Y = 150$$

$$0.25$$

- $C = 100 + 0.75 \times 600 = \text{Rs } 550$

- $S = Y - C = 600 - 550 = \text{Rs } 50$

Question 14. Find national income from the following data: [CBSE 2012] Autonomous consumption = Rs 100 Marginal propensity to consume = 0.80 Investment = Rs 50

Answer: As given in the examination problem, Autonomous consumption or $C = 100$ Autonomous investment or $I = \text{Rs } 50$ MPC or $b = 0.80$ So, $AD = C + I = C + bY + I = 100 + 0.8 Y + 50 = 150 + 0.8 Y$ As we know that the equilibrium level of national income in two sector model is determined where, $AS = AD$

$$Y = 150 + 0.8Y$$

$$Y - 0.8Y = 150 \quad Y(1-0.8) = 150$$

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

$$Y = \text{Rs } 750$$

Question 15. An economy is in equilibrium. Find Marginal Propensity to Consume from the following: [CBSE 2015] National Income = 2000 Autonomous Consumption = 400 Investment Expenditure = 200

Answer: Autonomous consumption or $C = \text{Rs } 400$ Equilibrium level of income or $Y = \text{Rs } 2000$ MPC or $b = ?$

At equilibrium, $Y = C + I$

$[AD = AS = Y \text{ and } AD = C + I] \quad Y = C + bY + I$

$$2000 = 400 + b(2000) + 200 \quad 2000 - 600 = b(2000)$$

$$1400 = b(2000)$$

$$\text{MPC}(b) = 0.7$$

Question 16. An economy is in equilibrium. Calculate the Investment Expenditure from the following: [AI 2015] National Income = 800

Marginal Propensity to Save = 0.3 Autonomous Consumption = 100

Answer: Autonomous consumption or $C = \text{Rs } 100$ Equilibrium level of income or $Y = \text{Rs } 800$ MPS = 0.3

MPC or $b = 1 - \text{MPS} = 0.7$ At equilibrium, $Y = C + I$

$[AD = AS = Y \text{ and } AD = C + I]$

$$Y = 100 + 0.7Y + I$$

$$800 = 100 + 0.7(800) + I$$

$$800 = 100 + 560 + I$$

$$I = 140$$

Question 17. As a result of increase in investment by Rs 125 crore national income increases by Rs 500 crore. Calculate marginal propensity to consume. [CBSE 2008]

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Answer: Multiplier $k =$

We also know that Multiplier (k)

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

or or $4 - 4 \text{ MPC} = 1$ or $\text{MPC} = 3/4 = 0.75$

Question 18. As a result of increase in investment national income increases by Rs 600 crore. If marginal propensity to consume is 0.75, calculate the increase in investment. [CBSE 2008]

Answer: Multiplier (k)

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

We also know that k

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Hence, change in investment = Rs 150 crore

Increase in investment = Rs 150 crore

Question 19. If marginal propensity to consume is 0.9, what is the value of multiplier? How much investment is needed if national income increases by Rs 5,000 crore? [CBSE 2008]

Answer: Multiplier (k)

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

We also know that k

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Hence, change in investment
= Rs 500 crores

Multiplier (k) = 10;

Increase in investment = Rs 500 crore

Question 20. An increase of Rs 250 crore in investment in an economy resulted in total increase in income of Rs 1,000 crore. Calculate the following: (a) Marginal propensity to consume (MPC), (b) Change in saving, (c) Change in consumption expenditure, (d) Value of multiplier. [CBSE Sample Paper 2008]

Answer: Multiplier k



Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

=

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

We know that Multiplier (k)

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

$$4 - 4MPC = 1$$

$$MPC = 3/4 = 0.75$$

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

$$0.75 =$$

So, change in consumption expenditure (C) = Rs 750 crore
 Change in Saving = Change in Income - Change in Consumption Expenditure
 So, Change in Saving = Rs 1,000 crore - Rs 750 crore = Rs 250 crore

(a) Marginal propensity to consume = 0.75

(b) Change in saving = Rs 250 crore

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(c) Change in consumption expenditure = Rs 750 crore

(d) Value of multiplier = 4

IV. True Or False

Giving reasons, state whether the following statements are true or false:

Question 1. Value of investment multiplier varies between zero and infinity. [CBSE 2010]

Answer: False. The value of investment multiplier varies between unity and infinity. This can be proved as follows, When $MPC = 0$,

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 2. When marginal propensity to consume is zero, the value of investment multiplier will also be zero. [CBSE AI2010]

Answer: False. When $MPC = 0$, the value of investment multiplier will be equal to unity.

This is shown as,

Multiplier (k) =

When $MPC = 0, k = 1/(1-0) = 1$

Question 3. When marginal propensity to consume is greater than marginal propensity to save, the value of investment multiplier would be greater than 5. [CBSE 2010]

Answer: False. Case I: When $MPC > MPS$ (i.e., $MPC = 0.6$ and $MPS = 0.4$), the value of the investment multiplier,

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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Case II: When $MPC > MPS$ (i.e., $MPC = 0.9$ and $MPS = 0.1$), the value of the investment multiplier,

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Thus, this statement is false because it is not true in all cases.

Question 4. When investment multiplier is 1, the value of marginal propensity to consume is zero. [CBSE (F) 2010]

Answer: The statement is true. When the value of $k = 1$, $MPC = 0$

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 5. If the ratio of marginal propensity to consume and marginal propensity to save is 4 : 1, the value of investment multiplier will be 4. [CBSE AI 2010]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

V. Long Answer Type Questions (6 Marks)

Question 1. Why must aggregate demand be equal to aggregate supply at the equilibrium level of income and output? Explain with the help of a diagram. Or [CBSE 2006] Explain how is equilibrium level of income and employment established through AD and AS?

Or

Explain determination of equilibrium level of income using consumption plus investment approach. Use diagram. [CBSE 2008]

Answer:

1. It refers to the point that has come to be established under the given condition of aggregate demand and aggregate supply, and has tendency to stick to that level under this given condition where Aggregate Demand = Aggregate Supply.
2. If due to some disturbance, we divert from that position, the economic forces will work in such a manner so as to drive us back to the original position, i.e., aggregate demand is equal to

aggregate supply.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

3. In the above mentioned figure, at point P, income = consumption, which is known as to be a break-even point. The equilibrium level of national income is attained at point E, where aggregate demand = aggregate supply.
4. If due to some disturbance we divert from our position, like when $AD > AS$ [at Y_2], then, production will have to be increased to meet the excess demand. Consequently, national income will increase. As we know positive relationship exists between national income and consumption, so consumption will increase, which will thereby increase the aggregate demand till we reach the equilibrium.
5. As against it, when $AD < AS$ [at Y_1], then there would be stockpiling and producers will produce less. National income will fall and as a result consumption will start falling, which will thereby reduce the aggregate demand till we reach the equilibrium.

Question 2. Explain the meaning of equilibrium level of income and output using saving and investment approach. Use a diagram. [CBSE 2008, Sample Paper 2010] Or What changes will take place to bring an economy in equilibrium if (i) planned savings are greater than planned investment, and (ii) planned savings are less than planned investment.

Or [CBSE.2009]

Using the 'saving and investment' approach explain how is the equilibrium level of national income determined? Also explain what will happen if the equilibrium condition is not fulfilled.

[Sample Paper 2013] Or

Explain how the economy achieves equilibrium level of income using Savings-Investment (S-I) approach. [CBSE Sample Paper 2016]

Answer:

1. It refers to the point that has come to be established under the given condition of aggregate demand and aggregate supply, and has tendency to stick to that level under this given condition where Aggregate Demand (AD) = Aggregate Supply (AS).

$$AD = AS$$

$$CONSUMPTION(C) + Investment(I) = CONSUMPTION(C) + Saving(S)$$

$$I = S$$

2. If due to some disturbance, we divert from that position, the economic forces will work in such a manner so as to drive us back to the original position, i.e., Saving is equal to Investment.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

3. In the above figure, the equilibrium level of national income is attained at point E, where saving = investment which is derived from a point where $S = I$.
4. If due to some disturbance we divert from our position like when investment > saving [at Y2], then production will have to be increased to meet the excess demand. Consequently, national income will increase leading to rise in saving until saving becomes equal to investment. It is here that equilibrium level of income is established because what the savers intend to save becomes equal to what the investors intend to invest.
5. As against it, when saving > investment [at Y1], then there would be stockpiling and producers will produce less. National income will fall and as a result saving will start falling until it becomes equal to investment. It is here the equilibrium level of income is derived.

Question 3. Explain the working of investment multiplier with the help of a numerical example. Or [CBSE 2005]

Explain with the help of a numerical example how does increase in investment in an economy affect its level of income? [CBSE AI 2005]

Or

Explain the dynamic multiplier. Or

Explain the income propagation process due to change in investment.

Or

Explain the process of working of the 'investment multiplier with the help of a numerical example. [CBSE Sample Paper 2014]

Answer: The process of investment multiplier is as under:

1. It can be illustrated with the help of a simple example. We know that one man's expenditure is another man's income.
2. Suppose, the government of a country spends Rs 100 crore on building roads. National income of the country automatically rises by Rs 100 crore in Round 1.
3. Now suppose MPC is 0.5, people working in the investment industry will spend Rs 50 crore on new consumption goods.
4. The consumer goods industry will have an extra income of Rs 50 crore. Assume the MPC for the whole society is 0.5, people working in these consumer goods industry would again spend 50% of their additional income of Rs 50 crore (which works out to be 25 crore) on more consumer goods.
5. These Rs 25 crore will, thus, become the income for others. This will continue till total increase in income becomes k times the increment of investment.

6. The process of income generation has been shown in the following table:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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VI. Higher Order Thinking Skills

Question 1. In an economy the entire increase in income is saved. What will be the value of multiplier? [1 mark]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 2. There is increase in investment of Rs 1000 crore in an economy. MPC is zero. What is the total increase in income? Calculate. [3-4 Marks]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 3. Investment increases by Rs 500 crores in an economy. MPS is zero. What is the total increase in income? Calculate.[3-4 Marks]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

There is infinite increase in income.

Question 4. Investment in an economy increases by Rs 700 crore. Suppose MPS is 1. Calculate increase in national income.[3-4 Marks]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 5. Derive the multiplier when MPS is:

(i) 0.10 (ii) 0.20 (iii) 0.25.

Using these multiplier values, find the change in the equilibrium level of income that results from Rs 20 crore decrease in investment. [3-4 Marks]



Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 6. The savings function of an economy is $S = -200 + 0.25 Y$. The economy is in equilibrium when income is equal to Rs 2,000. Calculate: [3-4 Marks]

(a) Investment expenditure at equilibrium level of income.

(b) Autonomous consumption.

Answer: $S = -200 + 0.25 Y$

(a) At equilibrium planned savings are equal to planned investment. Equilibrium level of income is ?2,000. Substituting the value of Y in the savings function, we get;

$S = -200 + 0.25 \times 2,000$ $S = 300$; $I = \text{Rs } 300$ Thus, investment expenditure at equilibrium level of income is Rs 300.

(b) Consumption + Savings = Income Autonomous consumption means the level of consumption expenditure when income is zero.

When $Y = 0$, Savings = -200 So, autonomous consumption = Rs 200

Question 7. What are the elements that private investor demand for investment depends? [3-4 Marks]

Answer: A private investor's demand for investment depends on two things:

(a) The rate of return on investment or M.E.I: The expected rate of return from an additional unit of investment is called marginal efficiency of investment (M.E.I). It is defined as the expected rate of return of an additional unit of capital goods. M.E.I is very important factor in determining the investment demand. M.E.I. is determined by two factors:

1. **Supply Price:** The cost of replacing the machine under consideration with a brand new machine is known its supply price. For example, if a machine of Rs 1 lakh is replaced in place of old machine, then Rs 1 lakh is the supply price.
2. **Prospective Yields:** It refers to expected net returns (of all costs) from the capital asset over its lifetime. For example, if the given machine is expected to yield revenue of Rs 10,000 and running expenditure is Rs 2000, the prospective yield will be, $10000 - 2000 = \text{Rs } 8000$.
3. **Formula of Marginal efficiency of investment:** In the given examples, marginal efficiency of investment will be, $8000 \times 100 = 8\%$, 10000

(b) **The Market Rate of Interest:** It refers to cost of funds borrowed for financing the investment. There exists inverse relationship between rate of interest and investment demand. Higher interest implies lower level of investment demand.

(c) **Decision whether to invest or not** The investor goes on making additional investments until M.E.I becomes equal to the rate of interest. If M.E.I is greater than the rate of interest, the investors has to increase the investment and if the rate is higher than the M.E.I, no investment is to be made.

For example, if an entrepreneur has to pay 15% market rate of interest on the loan taken by him and

he expected rate of profit i.e., M.E.I. is 30%, then he will surely go for the investment and will continue making investment till M.E.I. = Rate of Interest (ROI).

Question 9. In an economy the autonomous investment is 60 and the marginal propensity to consume is 0.8. If the equilibrium level of income is 400, then the autonomous consumption is 30. True or False? Justify your answer.[CBSE Sample Paper 2014] [3 Marks]

Answer: At equilibrium $AD = C + I = Y$..(i)

$I = 60$

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

$C =$ + bY

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

$=$ + $0.8Y$

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

If equilibrium level of income is 400, then $C =$ +

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

$0.8 \times 400 =$ + 320

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Thus, 60 +

+320 = 400

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

= 20

The given value of autonomous consumption is incorrect. The correct value is 20.

VII. Value Based Question

Question 1. Saving provides economic security in future, but why is it not good from the viewpoint of investment multiplier?[1 Mark]

Answer: Money supply is reduced by increase in savings which creates the situation of deficient demand in economy; consequently it reduces the functioning of investment multiplier.

Value: Analytic.

VIII. Application Based Questions

Question 1. In an economy the equilibrium level of income is Rs 12,000 crore. The ratio of marginal propensity to consume and marginal propensity to save is 3: 1. Calculate the additional investment needed to reach a new equilibrium level of income of Rs 20,000 crore.[CBSE AI 2010][3-4 Marks]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 2. If an additional investment of Rs 100 crore increases the income by Rs 100 crore in the first round of the multiplier process, by Rs 50 crore in the second round, by Rs 25 crore in the third round and so on. Determine the total increase in income. [3-4

Marks]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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I. Very Short Answer Type Questions (1 Mark)

Question 1. What is meant by excess demand in macroeconomics? [CBSE 2009]

Answer: When in an economy aggregate demand exceeds “aggregate supply at full employment level”, the demand is said to be an excess demand.

Question 2. Define inflationary gap. [CBSE 2008]

Answer: When in an economy aggregate demand exceeds “aggregate supply at full employment level”, the demand is said to be an excess demand and the gap is called inflationary gap.

Question 3. Give the meaning of deficient demand.

Answer: When in an economy aggregate demand falls short of aggregate supply at full employment level, the demand is said to be as deficient demand.

Question 4. Define deflationary gap. [CBSE 2008]

OR

Give the meaning of deflationary gap. [CBSE 2010]

Answer: When in an economy aggregate demand falls short of aggregate supply at full employment level, the demand is said to be deficient demand and the gap is called deflationary gap.

Question 5. State two measures by which a central bank can attempt to reduce the inflationary gap.

Answer:

1. Increase in cash reserve ratio.
2. Increase in marginal requirement.

Question 6. What is the impact of increase in margin requirements?

Answer: Increase in margin requirements discourages borrowings and decreases the aggregate demand.

Question 7. Give the meaning of full employment.[CBSE 2008]

Answer: Full employment equilibrium refers to the situation where aggregate demand = aggregate supply and all those who are able to work and willing to work (at the existing wage rate) are getting work.

Question 8. Give the meaning of involuntary unemployment.[CBSE 2008, 09, Sample Paper 2010]

Answer: Involuntary unemployment refers to a situation in which all able and willing persons to work at existing wage-rate do not find work. They are rendered unemployed against their wish. Hence, it is termed as involuntary unemployment.

Question 9. Is it necessary that equality between AD and AS is established at the full employment level?

Answer: No, it is not necessary that full employment occurs when $AD = AS$. Equilibrium can be achieved at full employment level, under employment level or at over full employment level.

Question 10. What is meant by full employment equilibrium?

Answer: Full employment equilibrium refers to a situation when equilibrium is attained i.e., aggregate demand is equal to aggregate supply at full employment level.

Question 11. What is underemployment equilibrium?[CBSE 2008]

Answer: Underemployment equilibrium refers to a situation when equilibrium is attained i.e., aggregate demand is equal to aggregate supply below full employment level or when resources are not fully employed.

Question 12. What is the meaning of over full employment equilibrium?

Answer: Over full employment level refers to a situation when equilibrium is attained, i.e., aggregate demand is equal to aggregate supply beyond the full employment level.

II. Multiple Choice Questions (1 Mark)

Question 1. Name the situation under which aggregate demand exceeds aggregate supply at the full employment level,

- (a) Excess demand (b) Excess supply
(c) Deflationary gap (d) None of them

Answer: (a)

Question 2. Name the situation under which aggregate demand falls short of aggregate supply

at full employment level.

- (a) Excess demand (b) Excess supply
(c) Inflationary gap (d) None of them

Answer: (b)

Question 3. What is the impact of deficient demand on production and employment?

- (a) Increase

- (b) Decrease
- (c) Remains constant
- (d) None of them

Answer: (b)

Question 4. The various fiscal policy measures that can increase aggregate demand and thus, control the problem of deficient demand are:

- (a) Increasing the level of government expenditure.
- (b) Reduction in the level of taxes.
- (c) A mix of increasing government expenditure and decreasing the rate of taxes
- (d) All of them

Answer: (d)

Question 5. The various fiscal policy measures that can decrease aggregate demand, and thus, control the problem of excess demand are:

- (a) Reducing the level of government expenditure.
- (fa) Increasing the amount of taxes.
- (c) A mix of reducing government expenditure and increasing tax rates
- (d) All of them

Answer: (d)

Question 6. The various monetary policy measures that can increase aggregate demand, and thus, control the problem of deficient demand are:

- (a) Reduction in bank rate.
- (b) Purchase of government securities in the open market by the central bank.
- (c) Reduction in CRR and SLR.
- (d) All of them

Answer: (d)

Question 7. The various monetary policy measures that can decrease aggregate demand, and thus, control the problem of excess demand are:

- (a) Increase in the bank rate.
- (b) Sale of government securities in the open market by the central bank.
- (c) Raising CRR and SLR.
- (d) All of them

Answer: (d)

III. Short Answer Type Questions (3-4 Marks)

Question 1. What are the reasons or causes for excess demand?

Answer: The main reasons for excess demand are apparently the increase in the following components of aggregate demand:

1. Increase in household consumption demand due to rise in propensity to consume.
2. Increase in private investment demand because of rise in credit facilities.
3. Increase in public (government) expenditure.
4. Increase in export demand.
5. Increase in money supply or increase in disposable income.

Question 2. What are impacts or effects of excess demand on price, output, employment?

Answer:

1. **Effect on General Price Level:** Excess demand gives a rise to general price level because it arises when aggregate demand is more than aggregate supply at a full employment level. There is inflation in economy showing inflationary gap.
2. **Effect on Output:** Excess demand has no effect on the level of output. Economy is at full employment level and there is no idle capacity in the economy. Hence output can't increase.

3. **Effect on Employment:** There will be no change in the level of employment also. The economy is already operating at full employment equilibrium, and hence there is no unemployment.

Question 3. What are the reasons or causes for deficient demand?

Answer: The main reasons for deficient demand are apparently the decrease in four components of aggregate demand:

1. Decrease in household consumption demand due to fall in propensity to consume.
2. Decrease in private investment demand because of fall in credit facilities.
3. Decrease in public (government) expenditure.
4. Decrease in export demand.
5. Decrease in money supply or decrease in disposable income.

Question 4. What are the impacts or effects of deficient demand on price (output) employment?

Answer:

1. **Effect on General Price Level:** Deficient demand causes the general price level to fall because it arises when aggregate demand is less than aggregate supply at full employment level. There is deflation in an economy showing deflationary gap.
2. **Effect on Employment:** Due to deficient demand, investment level is reduced, which causes involuntary unemployment in the economy due to fall in the planned output.
3. **Effect on Output:** Low level of investment and employment implies low level of output.

Question 5. Explain the role of Government expenditure and Open Market Operation in reducing AD/excess demand. [CBSE 2004C, 06, CBSE 2011; A 11]

Answer: (a) Government Expenditure:

1. Government has to invest huge amount on public works like roads, buildings, irrigation works, etc.
2. During inflation, government should curtail (reduce) its expenditure on public works like roads, buildings, irrigation works thereby reducing the money income of the people and their demand for goods and services.

(b) Open Market Operation:

1. It consists of buying and selling of government securities and bonds in the open market by central bank.
2. In a situation of excess demand leading to inflation, central bank sells government securities and bonds to commercial bank. With the sale of these securities, the power of commercial bank of giving loans decreases, which will control excess demand.

Question 6. Differentiate between full employment and underemployment equilibrium.

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 7. What is meant by Margin Requirement? How does the Central Bank use this measure to control deflationary conditions in an economy?[CBSE Sample Paper 2016]

Answer:

1. Business and traders get credit from commercial bank against the security of their goods. Bank never gives credit equal to the full value of the security. It always pays less value than the security.
2. So, the difference between the value of security and value of loan is called marginal requirement.
3. In a situation of deficient demand leading to deflation, central bank decreases marginal requirements. This encourages borrowing because it makes people get more credit against their securities.

IV. True Or False

Are the following statements true or false? Give reasons.

Question 1. To control deflation the central bank should increase the bank rate.

Answer: False. The central bank should decrease the bank rate in order to control deflation.

Question 2. Purchase of government securities by the central bank in the open market is an appropriate policy to check depression in the economy.

Answer: True. To check depression the central bank should purchase government securities from the open market, so as to increase the availability of credit in the economy.

Question 3. To correct the deflationary gap, availability of credit should be increased.

Answer: True. Availability of credit should be increased to raise the level of aggregate demand.

Question 4. Fiscal policy has a direct effect on producing sector of the economy.

Answer: False. Fiscal policy has a direct effect on all the sectors of the economy.

Question 5. Equilibrium below full employment level does not lead to fall in output level.

Answer: False. Equilibrium below the full employment level leads to deflation, which causes low level of investment and employment implies low level of output.

Note: As per CBSE guidelines, no marks will be given if reason to the answer is not explained.

V. Long Answer Type Questions (6 Marks)

Question 1. Explain the concept of underemployment equilibrium with the help of a diagram. Show on the same diagram the additional investment expenditure required to

reach full employment equilibrium.[CBSE 2004] OR

Explain the meaning of underemployment equilibrium. Explain two measures by which full employment equilibrium can be reached. [A/2013 (Set-7)]

Answer:

- Underemployment equilibrium refers to a situation when equilibrium is attained i.e., aggregate demand is equal to aggregate supply below full employment level or when resources are not fully employed.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

- In the above diagram full employment level of national income is attained at point E, but due to deficient demand, aggregate demand shifts downward from AD to ADO and new equilibrium is attained at point E₁; which is below full employment level. The aggregate demand shifts downward because of the following reasons.
 - Decrease in household consumption demand due to fall in propensity to consume.
 - Decrease in private investment demand because of fall in credit facilities.
 - Decrease in public (government) expenditure.
 - Decrease in export demand.
 - Decrease in money supply or decrease in disposable income.
- In order to achieve full employment equilibrium deficiency of demand must be corrected through additional investment expenditure. In the diagram deficiency of AD = AB. Thus, AB amount of additional investment is required to reach the level of full employment.

Question 2. Differentiate between inflationary gap and deflationary gap. Show deflationary gap on a diagram. Can this gap exist at equilibrium level? Explain. [CBSE, 2004, AI 2013]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Yes, deflationary gap can exist at equilibrium level of income. In the below figure equilibrium is

attained at an equilibrium point E, when deflationary gap is EB.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 3. Explain the concept of Inflationary Gap. Explain the role of Repo Rate in reducing this gap. [CBSE 2015] Or

What is meant by Repo Rate? How does the Central Bank use this measure to control inflationary conditions in an economy? [CBSE Sample Paper 2016]

Answer:

1. Inflationary gap is the gap showing excess of current aggregate demand over 'aggregate supply at the level of full employment'. It is called inflationary because it leads to inflation (continuous rise in prices).
2. It can be explained with the help of following diagram:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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3. (i) Repo rate is the rate at which commercial bank borrow money from the central bank for short period by selling their financial securities to the central bank.
(ii) These securities are pledged as a security for the loans.
(iii) It is called Repurchase rate as this involves commercial bank selling securities to RBI to borrow the money with an agreement to repurchase them at a later date and at a predetermined price.
(iv) So, keeping securities and borrowing is repo rate.
(v) In a situation of excess demand leading to inflation,
 - Central bank raises repo rate that discourages commercial banks in borrowing from central bank as it will increase the cost of borrowing of commercial bank.
 - It forces the commercial banks to increase their lending rates, which discourages borrowers from taking loans, which discourages investment.

- Again high rate of interest induces households to increase their savings by restricting expenditure on consumption.
- Thus, expenditure on investment and consumption is reduced, which will control the excess demand.

Question 4. Explain the concept of Deflationary Gap and the role of ‘Open Market Operations’ in reducing this gap.[CBSE 2015]

Answer:

1. Deflationary gap is the gap showing deficient of current aggregate demand over ‘aggregate supply at the level of full employment. It is called deflationary because it leads to deflation (continuous fall in prices).
2. It can be explained with the help of following diagram:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

3. (i) Open Market Operation consists of buying and selling of government securities and bonds in the open market by central bank.
(ii) In a situation of deficient demand leading to deflation, central bank purchases government securities and bonds from commercial bank. With the purchase of these securities, the power of commercial bank of giving loans increases, which will control deficient demand.

Question 5. What is ‘deficient demand’? Explain the role of ‘Bank Rate’ in removing it.[AI 2015]

Answer:

1. When in an economy, aggregate demand falls short of aggregate supply at full employment level, the demand is said to be a deficient demand.
2. It can be explained with the help of following diagram:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

3. (i) Bank rate is the rate of interest at which central bank lends to commercial banks without any collateral (security for purpose of loan). The thing, which has to be remembered, is that

central bank lends to commercial banks and not to general public.

(ii) In a situation of deficient demand leading to deflation,

- Central bank decreases bank rate that encourages commercial banks in borrowing from central bank as it will decrease the cost of borrowing of commercial bank.
- Decrease in bank rate makes commercial bank to decrease their lending rates, which encourages borrowers from taking loans, which encourages investment.
- Again low rate of interest induces households to decrease their savings by increasing expenditure on consumption.
- Thus, expenditure on investment and consumption increase, which will control the deficient demand.

Question 6. What is 'excess demand'? Explain the role of 'Reverse Repo Rate' in removing it. [AI 2015]

Answer:

1. When in an economy, aggregate demand exceeds "aggregate supply at full employment level", the demand is said to be an excess demand.
2. It can be explained with the help of following diagram:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

3. (i) Reverse Repo Rate is the rate at which the central bank (RBI) borrows money from commercial bank.
(ii) In a situation of excess demand leading to inflation, Reverse repo rate is increased, it encourages the commercial bank to park their funds with the central bank to earn higher return on idle cash. It decreases the lending capability of commercial banks, which controls excess demand.

VI. Higher Order Thinking Skills

Question 1. It is necessary that the equilibrium level of national income is always at a full employment level. Explain this statement. [6 Marks]

Answer: It is not necessary because equilibrium level of national income can be attained:

1. At full employment level.
2. Over full employment level, or above the full employment level (in case of excess demand).
3. Underemployment level or below full employment level (in case of deficient demand).
1. At full employment equilibrium level: Full employment equilibrium refers to a situation when equilibrium is attained, i.e., aggregate demand is equal to aggregate supply at full employment level.

In the given diagram, full employment level of national income and equilibrium level is

attained at Point E. So, equilibrium is possible at full employment level.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

2. Over full employment level or Above the full employment level: Over full employment level refers to a situation when equilibrium is attained, i.e., aggregate demand is equal to aggregate supply beyond full employment level.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

In the given diagram full employment level of national income is attained at point E, but due to the excess demand, the aggregate demand shifts upward from ADO to ADO₁. Due to shift in AD the new equilibrium is attained at point E₁ which is above the equilibrium level.

3. Underemployment equilibrium: It refers to a situation when equilibrium is attained, i.e., aggregate demand is equal to aggregate supply below the full employment level or when resources are not fully employed.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

In the above diagram full employment level of national income is attained at point E but due to deficient demand, aggregate demand shifts downward from ADO to AD₁ and new equilibrium is attained at point E_t, which is below full employment level.

VII. Value Based Questions

Question 1. In Indian market, money supply is the reason of rising price level. Explain

any one measure of central bank to control money supply? [3 Marks]

Answer: Explain any one reason:

1. Bank rate
2. Cash reserve ratio (CRR)
3. Statutory liquidity ratio (SLR)

Value : Critical thinking

Question 2. Excess money supply is necessary for rapid economic development but it creates inflationary situation. Write any two fiscal measures to control inflationary situation. [3 Marks]

Answer: Fiscal Measures:

1. Increase in tax rates (Explain)
2. Reduce public expenditure (Explain)

Value : Critical thinking

Question 3. In India unemployment is a major problem, If aggregate demand is equal to aggregate supply, can it be called a situation of equilibrium? [1 Mark]

Answer: Yes, but it will be underemployment equilibrium, and there exists a voluntary unemployment in an economy.

Value : Problem solving

Question 4. Increase in money supply is an effective measure to control economic depression, but it creates the burden of borrowing on economy. Explain any two measures by which economic depression can be controlled even in the situation of increase in money supply. [3 Marks]

Answer: (a) Decrease in bank rate. (Explain) (b) Decrease in statutory liquidity ratio (SLR) (Explain).

Value : Critical thinking

VIII.Applications Based Questions

Question 1. Depression is a high-handed monster, and if handled carefully it is not so troublesome. Comment. [3 Marks]

Answer:

1. Depression reflects slowdown of economic activities on all fronts and therefore is a cause of concern for the government and society at large.
2. However, if tackled carefully taking appropriate monetary and fiscal measures, it may prove useful.
3. As it has happened in 1929 in America, and also in the years from 2008 to 2012 in the context of slow down of the Indian economy.

Question 2. Small investors (such as households) deposit their savings to sustain their livelihood present and future, but government reduces interest rate for boosting economy. This is inequitable. How? [3-4 Marks]

Answer:

1. Households mobilize their savings and deposits it in the banks to earn interest for meeting their current and future needs.
2. If there is a fall in the interest rate, they get less interest, and, hence, find it difficult to sustain their livelihood.
3. But, on the other hand, RBI thinks of reducing interest rate for boosting the climate of investment.
4. There is a contradiction between the two, because increase in investment promotes aggregate demand and output while savings is a leakage from flow of income, and it should be resolved in a manner so that no one suffers.

Question 3. Monetary measures controlling the situations of inflationary and deflationary gaps are confined only to regular and white transactions. They do not

reflect the real situation. Comment. [3 Marks]

Answer: In India, in unorganized sectors such as small industries and agriculture, there are vast activities relating to aggregate demand and aggregate supply which are not reflected while assessing the gaps. It is because of these activities that the slowdown effect, that affected a considerable part of the world in 2008, did not affect India.

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Question 1. Explain why public goods must be provided by the government? [3-4 Marks]

Answer:

1. Public goods are those goods and services for which consumption by some individuals does not reduce the amount available to others.
2. For example parks, roads, water, bridges, national defense etc..
3. these goods are non-rival and non-excludable ones.
4. people receives benefits from public goods but do not pay for them. Such a goods can only prepared by government.

**Question 2. Distinguish between revenue expenditure and capital expenditure .
State the basis of classifying government expenditure into revenue and capital
expenditure. Give an example of each.**

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 3. The fiscal deficit gives the borrowing requirement of the government Elucidate. [3-4 Marks]

Answer:

1. Fiscal deficit is defined as excess of total expenditure over total receipts (revenue and capital receipts) excluding borrowing. In the form of an equation:
Fiscal Deficit = Total Budget Expenditure – Total Budget Receipts (Net of borrowing)
= Total Expenditure (Revenue Expenditure + Capital Expenditure) – Revenue Receipts (Tax Revenue + Non-Tax Revenue) – Non-Debt Capital Receipts (Recovery of Loans + Dis-investment Proceeds)
= Revenue Deficit + Capital Deficit (excluding Borrowing)- Borrowing
= Net borrowing at home + Borrowing from RBI + Borrowing from abroad
2. Fiscal deficit shows total borrowing requirements of the government from all sources.
3. As the government borrowing increases, its liability in future to repay loan with interest also increases leading to a higher revenue deficit. Therefore, fiscal deficit should be as low as possible.

Question 4. Give the relationship between revenue deficit and fiscal deficit. [3-4 Marks]

Answer:

1. Fiscal deficit is always a wider concept than revenue deficit.
2. Revenue deficit is defined as the excess of government's revenue expenditure over revenue receipts. In terms of formula:
Revenue Deficit = Revenue Expenditures (RE) – Revenue Receipts (RR)
3. In short, there will be revenue deficit in a government budget when revenue expenditure exceeds revenue receipts.
4. Fiscal deficit is defined as the excess for all expenditure over total receipts net of borrowings.
5. Initially, Fiscal deficit does not take into account all types of receipts. It does not take into account borrowings. But finally they have to depend on borrowing to met fiscal deficit.
Fiscal Deficit = Revenue Deficit + Capital Deficit (Excluding Borrowing)- Borrowing
= Net borrowing at home + Borrowing from RBI + Borrowing from abroad

Question 5. Does public (government) debt impose a burden? Explain. [3-4 Marks]

Answer: Public debt is not always a blessing. Excessive use of it creates a lot of crisis in an economy; such as,

1. Hampers Economic Development of a Country: Loans are easily borrowed but it is very difficult to repay them. Generally, government imposes more taxes. It brings instability and is an obstacle in the economic development of a country.

2. Poses Threat to Political Freedom: Foreign loans and assistance lead to deep conflict among countries. The friction among countries challenges the political freedom.
3. Proves a Burden on Common Man: Loans taken for unproductive purposes, like war and armaments, are a burden on common man in the form of higher taxes.
4. Leads to Extravagant Spending: Public debt leads to unplanned spending. This provides incentive to the government to implement the schemes that require excessive expenditure.
5. Results in Drain of National Wealth: Repayment of foreign loans results in drain of wealth out of the country.

Question 6. Are fiscal deficits necessarily inflationary? [3-4 Marks]

Or

“Governments across nations are too much worried about the term fiscal deficit”. Do you think that fiscal deficit is necessarily inflationary in nature? Support your answer with valid reasons.

Answer:

1. Fiscal deficits are not necessarily inflationary.
2. As we know fiscal deficit shows borrowing requirement of the government.
3. If we borrow when there is a situation of underemployment in an economy i.e., in a situation of deficient demand, then it is not inflationary because in a situation of deficient demand output is held back because of lack of demand.
4. A high fiscal deficit (borrowing) is accompanied by higher demand and greater output which is not inflationary.
5. On the other hand, if we borrow at the full employment level, then it is inflationary in nature.
6. A high fiscal deficit (borrowing) is accompanied by higher prices because aggregate demand is greater than aggregate supply at the full employment level which is always inflationary.

Question 7. Discuss the issue of deficit reduction.[3-4 Marks]

Answer: The deficit in a government budget can be reduced by the following steps:

1. Taxes should be increased. Government can make a plan for rising direct taxes to increase its receipts can also be raised by increasing rates of taxes or by imposing new taxes.
2. Reduction in Government Expenditures: It can be done through making government activities more efficient through better planning of programmes and better administration.
3. The government can raise Receipts through the sale of shares in PSUs (Public Sector Undertaking).
4. Changing the scope and role of government by withdrawing from same areas where it operated before.

MORE QUESTIONS SOLVED

I. Very Short Answer Type Questions (1 Mark)

Question 1. Define government budget.

Answer: A government budget is an annual financial statement showing itemwise estimates of expected revenue and anticipated expenditure during a fiscal year.

Question 2. State any one objective of a government budget.

Answer: Activities to secure a reallocation of resources

Question 3. Define a tax.

Answer: A tax is a legally compulsory payment imposed by the government on income and profit of persons and companies without reference to any benefit. Tax is of two types: Direct tax and Indirect tax.

Question 4. Why is service tax an indirect tax?

Answer: Its impact and incidence lie on different persons.

Question 5. State any two sources of non-tax revenue receipts.

Answer:

1. Commercial revenue (profit and interest)

2. Administrative revenue fees, fines and penalties, escheats etc)

Question 6. Is borrowing by the government a revenue receipt?

Answer: No, it is not so because it creates a liability (for the government) of repayment.

Question 7. Why is tax not a capital receipt?

Answer: Tax is not a capital receipt because it leads neither to creation of liability nor to reduction in assets.

Question 8. Why is interest termed as a revenue receipt?

Answer: Interest is a revenue receipt because it creates neither any liability nor causes a reduction in the assets of the government.

Question 9. Why are borrowings a capital receipt?

Answer: They create a liability (in terms of repayment).

Question 10. Why are subsidies treated as revenue expenditure?

Answer: Subsidies are treated as revenue expenditure because they create neither any asset nor cause a reduction in any liability of the government.

Question 11. Why is repayment of loan a capital expenditure?

Answer: It reduces the liabilities of the government.

Question 12. Why is recovery of loans treated as a capital receipt?[CBSE All India 2005]

Answer: Recovery of loans is treated as a capital receipt because it reduces assets of the government.

Question 13. Why are receipts from taxes categorised as revenue receipts?

Answer: Receipts from taxes are categorised as revenue receipts because they create neither any liability nor cause a reduction in the assets of the government.

Question 14. What is meant by revenue deficit?

Answer: Revenue deficit refers to the excess of revenue expenditure of the government over its revenue receipts. Revenue Deficit = Revenue Expenditure - Revenue Receipts

Question 15. If the revenue receipts are Rs. 1,000 crore and revenue expenditure is Rs. 1,200 crore, how much will be the revenue deficit?

Answer: Revenue Deficit = Revenue Expenditure – Revenue Receipts = 1,200 – 1,000 = Rs. 200 crore.

Question 16. Define fiscal deficit.

Answer: Fiscal deficit is defined as excess of total expenditure over total receipts (revenue and capital receipts) excluding borrowing.

Question 17. What is the meaning of primary deficit?

Answer: Primary deficit refers to the difference between fiscal deficit of the current year and interest payments on the previous borrowings.

Question 18. How is primary deficit calculated?

Answer: Primary Deficit = Fiscal Deficit – Interest Payments

Question 19. What does zero primary deficit mean?

Answer: If primary deficit is zero, fiscal deficit = interest payments. It means the government has to borrow only for its interest commitments on earlier loans.

II. Multiple Choice Questions (1 Mark)

Question 1. Budget is placed before:

- (a) Lok Sabha
- (b) Rajya Sabha
- (c) Both Lok Sabha and Rajya Sabha
- (d) Parliament

Answer: (c)

Question 2. Budget is a:

- (a) Financial statement
- (b) Monetary statement
- (c) Political statement

(d) All of them

Answer: (a)

Question 3. Which article of the Constitution takes about the budget?

(a) Article 110 (b) Article 111

(c) Article 112 (d) Article 113

Answer: (c)

Question 4. One year period from 1 April to 31 March of next year is called a:

(a) Monetary year (b) Fiscal year

(c) Plan year (d) Tax year

Answer: (b)

Question 5. Capital receipts may come from:

(a) Market borrowings

(b) Provident funds

(c) Recoveries of loans

(d) All of them

Answer: (d)

Question 6. Find direct tax among the following taxes:

(a) Personal income tax

(b) Excise duty

(c) Sales tax

(d) Service tax

Answer: (a)

Question 7. Among the following types of taxes, find the indirect one.

(a) Gift tax

(b) Corporate income tax

(c) VAT

(d) Wealth tax

Answer: (c)

Question 8. If budgetary deficit is nil and borrowings and other liabilities are 70 crore, what is the amount of fiscal deficit?

(a) Nil (b) 30 crore

(c) Can't say (d) 70 crore

Answer: (d)

Question 9. When the government tries to meet the gap of public expenditure and public revenue through borrowing from the banking system, it is called

(a) deficit financing

(b) debt financing

(c) credit financing

(d) none of them

Answer: (a)

Question 10.is the difference between total receipts and total expenditure.

(a) Fiscal deficit

(b) Budget deficit

(c) Revenue deficit

(d) Capital deficit

Answer: (b)

Question 11. If borrowings and other liabilities are added to the budget deficit, we get

(a) revenue deficit

(b) capital deficit

(c) primary deficit

(d) fiscal deficit

Answer: (d)

Question 12. Payment of interest is __

(a) revenue expenditure.

(b) capital expenditure

(c) primary deficit.

(d) fiscal deficit

Answer: (a)

Question 13. If the total receipts are Rs.1000 crore and total expenditure is ₹1500 crore, how much will be the budgetary deficit?

(a) 500 crore (b) 1500 crore

(c) 1000 crore (d) -500 crore

Answer: (a)

Question 14. A government shows a primary deficit of ₹4400 crore. The revenue expenditure on interest payment is Rs.400 crore. How much is the fiscal deficit?

(a) 4000 crore (b) 4800 crore

(c) 4400 crore (d) -400 crore

Answer: (b)

Question 15. A government shows a primary deficit of Rs 10,000 crore. The revenue expenditure on interest payment is Rs 8000 crore. How much is the fiscal deficit?

(a) 18000 crore (b) 10000 crore

(c) 8000 crore (d) -8000 crore

Answer: (a)

Question 16. In a government budget, revenue deficit is Rs,50,000 crore and borrowings are Rs.75,000 crore. How much is the fiscal deficit?

(a) 50000 crore (b) 75000 crore (c) 25000 crore (d) -25000 crore

Answer: (b)

Question 17. Borrowing in government budget is: (Choose the correct alternative)[CBSE 2015]

(a) Revenue deficit

(b) Fiscal deficit

(c) Primary deficit

(d) Deficit in taxes

Answer: (b)

Question 18. The non – tax revenue in the following is: (Choose the correct alternative

(a) Export duty (b) Import duty (c) Dividends (d) Excise

Answer: (c)

Question 19. Primary deficit in a government budget is: (Choose the correct alternative)

(a) Revenue expenditure – Revenue receipts

(b) Total expenditure – Total receipts

(c) Revenue deficit – Interest payments

(d) Fiscal deficit – Interest payments

Answer: (d)

Question 20. Direct tax is called direct because it is collected directly from: (Choose the correct alternative)

(a) The producers on goods produced

(b) The sellers on goods sold

(c) The buyers of goods

(d) The income earners

Answer: (d)

Question 21. The government budget has a revenue deficit. This gets financed by:

(A) Borrowing

(B) Disinvestment

(C) Tax revenue

(D) Indirect taxes

(a) A and D (b) C and D

(c) A and B (d) C and D

Answer: (c)

Question 22. Which of the following statement is not true for fiscal deficit?

A fiscal deficit:

(a) represents the borrowing of the government.

(b) is the difference between total expenditure and total receipts of the government.

(c) is the difference between total expenditure and total receipts other than borrowing.

(d) increases the future liability of the government

Answer: (b)

Question 23. The government budget of a hypothetical economy presents the following information, which of the following value represents Budgetary Deficit, (all fig. in ? crores)

1. Revenue Expenditure = 25,000

2. Capital Receipts = 30,000

3. Capital Expenditure = 35,000

4. Revenue Receipts = 20,000

5. Interest Payments = 10,000

6. Borrowings = 20,000

(a) Rs. 12,000

(b) Rs. 10,000

(c) Rs. 20,000

(d) None of the above.

Answer: (b)

Question 24. Which of the following statement is true?

(a) Loans from IMF is a Revenue Receipt.

(b) Higher revenue deficit necessarily leads to higher fiscal deficit.

(c) Borrowing by a government represents a situation of fiscal deficit.

(d) Revenue deficit is the excess of capital receipts over the revenue receipts.

Answer: (c)

III. Short Answer Type Questions (3-4 Marks)

Question 1. Explain objective of stability of prices of government budget. [CBSE, (F) 2010] Or

Explain the 'economic stability' objective of a government budget. [CBSE, AI2011] Or Explain stabilising activities function of budget.

Answer:

1. Free play of market forces (or the forces of supply and demand) are bound to generate trade cycles, also called business cycles.
2. These refer to the phases of recession, depression, recovery and boom in the economy.
3. The government of a country is always committed to save the economy from business cycles. Budget is used as an important policy instrument to combat(solve) the situations of deflation and inflation.
4. By doing it the government tries to achieve the state of economic stability.

5. Economic stability leads to more investment and increases the rate of growth and development.

Question 2. Name two sources each of non-tax revenue receipts. [CBSE 2004]

Answer: Non-tax revenue refers to government revenue from all sources other than taxes called non-tax revenue. These are incomes, which the government gets by way of sale of goods and services rendered by different government departments. Its two sources are:

1. **Commercial Revenue (Profit and interest):** It is the revenue received by the government by selling the goods and services produced by the government agencies. For example, profit of public sector undertakings like Railways, BHEL, LIC etc. Government gives loan to State Government, union territories, private enterprises and to general public and earns interest receipts from these loans. It also includes interest and dividends on investments made by the government.
2. **Administrative Revenue:** The revenue that arises on account of the administrative function of the government. This includes:
 - (i) **Fee:** Fee refers to a payment made to the government for the services that it renders to the citizens. Such services are generally in public interest and fees are paid by those, who receive such services. For example, passport fees, court fees, school fees in government schools,
 - (ii) **License Fee:** License fee is a payment to grant a permission by a government authority. For example, registration fee for an automobile.

Question 3. Distinguish between: Revenue receipts and capital receipts. [CBSE 2005, 10]

Or
Distinguish between 'revenue receipt' and 'capital receipt' and give two examples of each. [CBSE 2007]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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Question 4. Distinguish between Direct tax and indirect tax.

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 5. Differentiate between Revenue Budget and Capital Budget.

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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Question 6. Differentiate between Developmental and Non-Developmental Expenditure.

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 7. What are the implications of a large revenue deficit? Give two measures to reduce this deficit. [CBSE Sample Paper 2010]

Answer:

1. Revenue deficit indicates dis-savings on government account because the government has to make up uncovered gap.
2. Revenue deficit implies that the government has to cover this uncovered gap by drawing upon capital receipts either through borrowing or through sale of its assets.
3. Since government is using capital receipts to meet generally consumption expenditure of the government which leads to an inflationary situation in the economy.

Two measures to reduced revenue deficit are :

1. Government should reduce its unproductive or unnecessary expenditure.
2. Government should increase its receipts from various sources of tax and non-tax revenue.

Question 8. What are implications of fiscal deficit? [A/2005; CBSE o6C, 07]

Answer:

1. **Causes Inflation:** An important component of government borrowing includes borrowing from the Reserve Bank of India. This invariably implies deficit financing or meeting deficit requirements of the government by way of printing more notes. This is a dangerous practice, though very convenient for the government. It increases circulation of money and causes inflation.
2. **Increase in Foreign Dependence:** Government also borrows from rest of the world. It increases our dependence on other countries. Foreign borrowing is often associated with economic and political interference by the lender countries. It increases our economic slavery.
3. **Financial Burden for Future Generation:** Borrowing implies accumulation of financial burdens for the future generations. It is for future generations to repay loans as well as the mounting interest thereon.
4. **Deficits Multiply Borrowings:** Payments of interest increases revenue expenditure of the government, causing an increase in its revenue deficit. Thus, a vicious circle set wherein deficits multiply borrowings.

IV. True Or False

Are the following statements true or false? Give reasons.

Question 1. Government budget is a statement of actual receipts and payments of the government.

Answer: False.

Reason: It is a statement of “Estimated’ (and not actual) receipts and payments of the government.

Question 2. Rise in revenue deficit will always lead to higher fiscal deficit.

Answer: False.

Reason: Fiscal deficit leads to rise in revenue deficit.

Question 3. Service tax is a indirect tax as its impact and incidence is on the same individual.

Answer: False.

Reason: Its burden can be shifted to others.

Question 4. Direct tax are generally ‘Proportional’ in nature.

Answer: False.

Reason: Direct taxes are generally ‘progressive’ in nature.

Question 5. Primary deficit is the difference between capital deficit and interest payments.

Answer: False.

Reason: Primary deficit is the difference between fiscal deficit and interest payments.

Question 6. Non-debt capital receipts only includes disinvestment.

Answer: False.

Reason: It also includes the recovery of loan.

Question 7. Fiscal deficit is non-inflationary.

Answer: False.

Reason: Fiscal deficit can be inflationary when we are at full employment level.

It is so because large fiscal deficits creates excess money supply that creates inflation.

Question 8. Expenditure made on the development of a railway line is a capital expenditure.

Answer: True.

Reason: This expenditure creates an asset for the railway and government.

Note: As per CBSE guidelines, no marks will be given if reason to the answer is not explained.

Note: As per CBSE guidelines, no marks will be given if reason to the answer is not explained.

V. Long Answer Type Questions (6 Marks)

Question 1 . Explain the role the government can play through the budget in influencing allocation of resources. [CBSE 2015] OR .

Explain the ‘allocation of resources’ objective of government budget.[CBSE 2011] OR

Explain the allocation function of a government budget. [CBSE AI2010]OR

Explain how government can influence allocation of resources through government budget.

Answer:

1. Private enterprises always desire to allocate resources to those areas of production where profits are high.
2. However, it is possible that such areas of production (like production of alcohol) may not promote social welfare.
3. Through its budgetary policy the government of a country directs ‘ the allocation of resources in a manner such that there is a balance between the goals of profit maximisation and social welfare.
4. Production of goods which are injurious to health (like cigarettes and whisky) is discouraged through heavy taxation.
5. On the other hand, production of “socially useful goods” (like electricity, ‘Khadij is encouraged through subsidies.

6. So, finally government has to reallocate resources in accordance to social and economic considerations in case the free market fails to do or does so inefficiently.

Question 2. Explain how the government can use the budgetary policy in reducing inequalities of incomes. [AI 2015] OR

How can a government budget help in reducing inequalities of income? Explain. [CBSE 2009]OR

How can a government budget be helpful in altering distribution of income in an economy? Explain.[CBSE 2010] OR

Explain 'redistribution of income' objective of government budget. [CBSE2011, A/2011] OR

Reduction in income inequalities raises welfare of the people. How can government help, through government budget, in this regard? Explain? [A/2013, C (Set /)]

Answer:

1. Budget of a government shows its comprehensive exercise on the taxation and subsidies.
2. A government uses fiscal instruments of taxation and subsidies with a view of improving the distribution of income and wealth in the economy.
3. A government reduces the inequality in the distribution of income and wealth by imposing taxes on the rich and giving subsidies to the poor, or spending more on welfare of the poor.
4. It will reduce income of the rich and raises the living standard of the poor, thus, leads to equitable distribution of income.
5. Expenditure on special anti poverty and employment schemes will be increased to bring more people above poverty line.
6. Public distribution system should be inferred so that only the poor could get foodgrains and other essential items at subsidised prices.
7. Equitable distribution of income and wealth is a sign of social justice which is as the principal objective of any welfare state in India.

Categorize the following items into Revenue and Capital Receipts

Question 1. Statement—Loan from the Australian government. [CBSE Delhi 2006]

Answer: Capital receipt.

Reason: It creates liability for the government.

Question 2. Statement—Corporation tax. [CBSE Delhi 2006, Sample Paper 10] OR

Statement—Income tax received by government.

Answer: Revenue receipt.

Reason: It creates neither any liability nor reduces any asset of the government.

Question 3. Statement—Grants received from International Monetary Fund

Answer: Revenue receipt.

Reason: It creates neither any liability nor reduces any asset of the government.

Question 4. Statement—Profits of public sector undertakings. [CBSE Sample Paper 2010]

Answer: Revenue receipt.

Reason: It creates neither any liability nor reduces any asset of the government.

Question 5. Statement—Sale of a public sector undertaking. [CBSE Delhi 2006]OR

Statement—Receipts from sale of shares of a public sector undertaking. [CBSE Sample Paper 2010]

Answer: Capital receipt.

Reason: It reduces assets of the government.

Question 6. Statement—Foreign aid against earthquake victims.

Answer: Revenue receipt.

Reason: It creates neither any liability nor reduces any asset of the government.

Question 7. Statement—Dividends on investments made by government.[CBSE Delhi 2006]

Answer: Revenue receipt.

Reason: It creates neither any liability nor reduces any asset of the government.

Question 8. Statement—Borrowings from public.

Answer: Capital receipt.

Reason: It creates liability for the government.

Question 9. Statement—Fees of a Government College.

Answer: Revenue receipt.

Reason: It creates neither any liability nor reduces any asset of the government.

Question 10. Statement—Recovery of loans. [CBSE Delhi 2006]

Answer: Capital receipt.

Reason: It reduces assets of the government.

Question 11. Statement—Loans recovered from public sector enterprises.

Answer: Capital receipt.

Reason: It reduces assets of the government.

Question 12. Statement—License and court fees received by the government in the year 2012-13

Answer: Revenue receipt.

Reason: It creates neither any liability nor reduces any asset of the government.

Question 13. Statement—Loan taken from the USA for the infrastructural developments.

Answer: Capital receipt.

Reason: It creates liability for the government.

Question 14. Statement—Sale of shares held by Government in a PSU.

Answer: Capital receipt.

Reason: It reduces assets of the government.

Question 15. Statement—Financial help from microsoft for the victims of flood affected areas.

Answer: Revenue receipt.

Reason: It creates neither any liability nor reduces any asset of the government

Question 16. Statement—Amount borrowed from Japan for construction of Metro.

Answer: Capital receipt.

Reason: It creates liability for the government.

Question 17. Statement—Dividend received by government from a company.

Answer: Revenue receipt.

Reason: It creates neither any liability nor reduces any asset of the government.

Question 18. Statement—Funds raised from public in the form of National Saving Certificates and Kisan Vikas Patras.

Answer: Capital receipt.

Reason: It creates liability for the government.

Question 19. Statement—Sale of 40% shares of a public sector undertaking to a private enterprise.

Answer: Capital receipt.

Reason: It reduces assets of the L government.

Question 20. Statement—Profits of LIC, a public enterprise.

Answer: Revenue receipt.

Reason: It creates neither any s liability nor reduces any asset of the government.

Categorize the following items into Direct and Indirect Taxes

Question 1. Statement—Corporation tax. [CBSE Foreign 2006]

Answer: Direct tax.

Reason: Its impact and incidence lie on the same person.

Question 2. Statement—Value Added tax. [CBSE Delhi 2010]

Answer: Indirect tax.

Reason: Its impact and incidence lie on different persons.

Question 3. Statement—Service tax. [CBSE Foreign 2006]

Answer: Indirect tax.

Reason: Its impact and incidence lie on different persons.

Question 4. Statement—Wealth tax. [CBSE Foreign 2006, Delhi 2010]

Answer: Direct tax.

Reason: Its impact and incidence lie on the same person.

Question 5. Statement—Indirect tax. [CBSE Foreign 2006]

Answer: Indirect tax.

Reason: Its impact and incidence lie on different persons.

Question 6. Statement—Income tax.

Answer: Direct tax.

Reason: Its impact and incidence lie on the same person.

Question 7. Statement—Entertainment tax.

Answer: Indirect tax.

Reason: Its impact and incidence lie on different persons.

Question 8. Statement—Corporate tax.

Answer: Direct tax.

Reason: Its impact and incidence lie on the same person.

Question 9. Statement—Excise duty.

Answer: Indirect tax.

Reason: Its impact and incidence lie on different persons.

Question 10. Statement—Custom duty.

Answer: Indirect tax.

Reason: Its impact and incidence lie on different persons.

Question 11. Statement—Capital Gains Tax.

Answer: Direct tax.

Reason: Its impact and incidence lie on the same person.

Categorize the following items into Revenue and Capital Expenditure

Question 1. Statement—Subsidies. [CBSE AI 2006]

Answer: Revenue expenditure.

Reason: It creates neither any asset nor reduces any liability of the government.

Question 2. Statement—Defence capital equipments purchased from Germany.

Answer: Capital expenditure.

Reason: It increases asset of the government.

Question 3. Statement—Grants given to State Governments. [CBSE AI 2006]

Answer: Revenue expenditure.

Reason: It creates neither any asset nor reduces any liability of the government.

Question 4. Statement—Construction of school building. [CBSE AI 2006]

Answer: Capital expenditure.

Reason: It increases asset of the government.

Question 5. Statement—Expenditure incurred on administrative and defence services.

Answer: Revenue expenditure.

Reason: It creates neither any asset nor reduces any liability of the government.

Question 6. Statement—Repayment of loan. [CBSE AI 2006]

Answer: Capital expenditure.

Reason: It reduces the liability of the government.

Question 7. Statement—Amount spent on construction of Bridges

Answer: Capital expenditure.

Reason: It increases asset of the government.

Question 8. Statement—Payment of salaries to staff of government hospitals.

Answer: Revenue expenditure.

Reason: It creates neither any asset nor reduces any liability of the government.

Question 9. Statement—Purchase of 20 cranes for the construction of flyovers

Answer: Capital expenditure.

Reason: It increases asset of the government.

Question 10. Statement—Amount borrowed from USA repaid.

Answer: Capital expenditure.

Reason: It reduces the liability of the government.

Question 11. Statement—Salary paid to Army officers.

Answer: Revenue expenditure.

Reason: It creates neither any asset nor reduces any liability of the government.

Question 12. Statement—Purchase of Metro coaches from Japan.

Answer: Capital expenditure.

Reason: It increases asset of the government.

Question 13. Statement—Repayment of Loan taken from the World Bank.

Answer: Capital expenditure.

Reason: It reduces the liability of the government.

Question 14. Statement—Grants given by central government to state government.

Answer: Revenue Expenditure.

Reason: It creates neither any asset nor reduces any liability of the government.

Question 15. Statement—Loan given to Union Territories

Answer: Capital expenditure.

Reason: It increases asset of the government.

Question 16. Statement—Interest paid on National Debt.

Answer: Revenue expenditure.

Reason: It creates neither any asset nor reduces any liability of the government.

Question 17. Statement — Expenditure on construction of Metro.

Answer: Capital expenditure.

Reason: It increases asset of the government.

Question 18. Statement—Pension paid to retired government employees.

Answer: Revenue expenditure.

Reason: It creates neither any asset nor reduces any liability of the government.

Question 19. 10% shares purchased by the government in a private company.

Answer: Capital expenditure.

Reason: It increases asset of the government.

VI. Higher Order Thinking Skills

Question 1. Define debt trap. [1 Mark]

Answer: It is a vicious circle set wherein the government takes more loans to repay earlier loans.

Question 2. Distinguish between revenue deficit and fiscal deficit. [CBSE 2009, 13] [3 Marks]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 3. Difference between primary deficit and fiscal deficit. [Delhi 2013] [3 Marks]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 4. How can a deficit be financed? [3 Marks]

Answer: A deficit can be financed in two ways:

1. **Monetary Expansion:** It means printing new notes to the extent of deficit. It involves government borrowings from the Central bank (Reserve Bank of India) through the issue of the treasury bills to the Central Bank. The Central Bank purchases the treasury bills in return for cash (procured by printing new notes). The government use this cash to finance the deficit.
2. The second method of financing the deficit is borrowing by the government from the public through market loans etc.
3. By borrowing from abroad (rest of the world).

Question 5. Can there be a fiscal deficit in a government budget without a revenue deficit? Explain. [CBSE Sample Paper 2008] [3-4 Marks]

Answer:

1. Yes, there can be a fiscal deficit in government budget without any revenue deficit.
2. Revenue deficit is a position where total revenue expenditure of the government exceeds its total revenue receipts.
3. Fiscal deficit is a position where total expenditure of the government exceeds sum total of its revenue receipts and non-debt capital receipts.

4. Hence, there can be a fiscal deficit without revenue deficit in following situations:
- When capital budget shows a deficit and revenue budget is balanced.
 - When deficit in capital budget is greater than surplus in revenue budget.

Question 6. Revenue deficit is the real deficit and not the fiscal deficit. How? [3 Marks]

Answer:

- Fiscal deficit is defined as excess of total expenditure over total receipts (revenue and capital receipts) excluding borrowing.
- In other words, it is equal to borrowings and borrowings are just an act of the government which may be finance interest payments of the government also.
- While revenue deficit exclusively takes into account current interest payment obligations of the government not connected with the actual activities.
- Thus, revenue deficit is more important than fiscal deficit.

Question 7. From the following data about a government budget find: (a) revenue deficit, (b) fiscal deficit and (c) primary deficit: [CBSE, All India 2011] [3 Marks]

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Answer: (a) Revenue deficit = Revenue expenditure – Revenue receipts (Tax revenue + Non-tax Revenue)

$$= 80 - (47+10) = \text{Rs. } 23 \text{ Arab}$$

(b) Fiscal deficit = Total expenditure (Revenue expenditure + Capital expenditure) – Revenue receipts (Tax revenue + Non-tax revenue) – Non-debt Capital Receipts (Capital receipts – borrowings)

$$= (80 + 0) - (47 + 10) - (34 - 32)$$

$$= 80 - 57 - 2 = \text{Rs. } 21 \text{ Arab}$$

(c) Primary deficit = Fiscal deficit – Interest payments

$$= 21 - 20 = \text{Rs. } 1 \text{ Arab}$$

8. Find (a) fiscal deficit and (b) primary deficit from the following items: [CBSE Sample Paper 2013] [3 Marks]

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Answer: (a) Fiscal deficit = Borrowings = Rs. 15000 crore.

(b) Primary deficit = Fiscal deficit – Interest payments = 15000 – 25% of (70000 – 50000) = 15000 – 25% of 20000 = 15000 – 5000 = Rs. 10000 crore.

VII. Value Based Questions

Question 1. There has been consistent rise in prices of fruits and vegetables in Delhi for sometimes. Which measures of budget will you support to reduce the prices of these

commodities? [1 Mark]

Answer: Prices of fruits and vegetables can be reduced by providing subsidies to the producer of fruits & Vegetables and the government should also provide fruits and vegetables at subsidised rates to the consumers through public distribution system.

Value : Problem solving

Question 2. Budget deficit creates disequilibrium in every economy, but in developing countries like India, why does government depend on it? [1 Mark]

Answer: Per capital income in developing countries like India is comparatively low so the tax receipts of the government are not sufficient, but on the other hand government has to incur heavy public expenditure for the development of economy so a government is compelled on budget deficit.

Value : Economic awareness

Question 3. In India a majority of population is lying below poverty line due to inequality of 'Income and Wealth'. How can budget be helpful in solving this problem? [1 Mark]

Answer: In Indian budget progressive tax system can be a good measure to remove the inequality of 'income and wealth' and government should provide social facilities like education, health and food grain to the poor at subsidized rates.

Value : Problem solving.

Question 4. Classify the following items into revenue expenditure and capital expenditure. Give reason for your answer. [3-4 Marks]

- (a) Free supply of stationary to the students by the government.
- (b) Economic assistance given according to Ladli scheme.
- (c) Expenditure on the construction of computer lab in school by the government.
- (d) Expenditure on Mid Day Meal given to students by the government.

Answer: (a), (b) and (d) are revenue expenditures because they neither create assets nor cause reduction in assets.

(c) is capital expenditure because it increases assets of the government. Value : Analytic

Question 5. In India, for the last several years, there has been deficit in the revenue account. How is it met or financed? [1 Mark]

Answer: Two measures to reduce revenue : deficit:

1. Government should reduce revenue expenditure.
2. To increase taxes, both direct and ; indirect.

Value : Analytic

Question 6. If you were to be appointed as the Finance Minister of India, which taxes would you prefer: direct taxes or indirect taxes and why? [3-4 Marks]

Answer: As we know, direct tax and indirect tax are complimentary to each other i.e., they are not substitutes to each other. There is really nothing to choose between direct taxes and indirect taxes as such. Both of them have their relative merits and demerits.

They differ from each other as:

1. Indirect taxes reach all the sections of the society; whereas direct taxes cannot reach all the sections.
2. Direct taxes can be highly progressive; whereas Indirect taxes are generally proportional.
3. Indirect taxes can be easily used to influence the consumption of specific commodities; whereas direct taxes cannot be used thus. In short, it is necessary to strike a balance between direct taxes and indirect taxes as a source of tax revenue.

Question 7. Should we rely exclusively on direct taxes for mobilizing tax revenue because indirect taxes are inequitable? Comment. [3 Marks]

Answer:

1. We cannot depend solely on direct taxes because they are progressive in nature and there is possibility of tax evasion.

2. But as against it indirect taxes are proportional in nature and are generally imposed on commodities (necessity goods etc.) which each and every individual purchase.
3. So, direct and indirect tax are important for providing funds for investment and for other social welfare considerations.

Question 8. Levy of taxes on all commodities without caring for their impact on the common man is not desirable. Comment. [3 Marks]

Answer:

1. Indirect taxes such as sales tax and excise duty fall heavily on the shoulders of a common man.
2. This means they are inequitable.
3. Therefore, in such a situation, tax basket should be a mixture of direct and indirect taxes both.

Question 9. It is not only difficult but impossible to tax all those who should be taxed, in India. Why? [1 Mark]

Answer: Due to lack of necessary information and disclosures required, tendency of the people to avoid taxes and lack of efficient implementation machinery, it is not possible to tax all those who should be taxed.

Question 10. In the government of India budget for the year 2013-14 the Finance Minister proposed to raise the excise duty on cigarettes. He also proposed to increase income tax on individuals earning more than ? One crore per annum.

Identify and explain the types of taxes proposed by the finance minister. Was the government's objective only to earn revenue themselves? What possible welfare objective could the government be considering? Explain. [6 Marks] [CBSE Sample Paper 2014]

Answer: (a) Excise Duty: Indirect Tax When (a) liability to pay a tax (Impact of tax) is on one person; and (b) the burden of that tax (Incidence of tax), falls on the other person, it is termed as indirect tax. (b) Income Tax: Direct Tax When (a) liability to pay a tax (Impact of Tax), and (b) the burden of that tax (Incidence of tax), falls on the same person, it is termed as direct tax. (c) Besides the objective of raising more revenue, the proposals also serve some welfare objectives.

1. First, raising excise duty on cigarettes makes cigarettes costlier and discourages smoking. Less smoking have positive influence on health and raises welfare of the people,
2. Secondly, raising income tax on incomes above ? one crore will help in reducing inequalities in income.
3. Thirdly, the extra revenue is raised from these proposals, and if spent on health and education of the poor it will do the welfare of the poor.

Question 11. Regulation of prices in the case of agricultural products is not only desirable but necessary. Explain. [3 Marks]

Answer:

1. As we know that agricultural production depends upon natural factors like rainfall, climate etc. these natural factors creates a situation of drought or surplus production.
2. Therefore, in such a situation for helping farmers in case of drought the government should fix a price lower than the market price (which is also known as price ceiling) and in case of the surplus production the government should fix a price higher than the market price (which is also known as price floor).
3. Surplus or shortages should be met by the government from its buffer stock operations through Public Distribution System (PDS) such as ration shops or fair price shops.

Question 12. We should try to regulate interest rates prevailing among farmers, weaker sections of society and poor villagers. How can we control it? [3-4 Marks]

Answer:

1. A government and monetary authorities fix the rate of interest which is based on bank rate fixed by the RBI and consequent interest rates are charged by the commercial banks.

2. In this regard we have regional rural banks being set up in rural areas to benefit the rural artisans, small and marginal labourers and weaker sections of the society.
3. They provide credit assistance at concessional lending rates.
4. However, weaker sections of society including poor farmers and villagers pay very high rate of interest which they pay to the moneylenders or zamindars.
5. Therefore, for reducing rate of interest for such people, some necessary steps should be taken such as promoting cooperative societies etc.



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Question 1. How is exchange rate determined under a flexible exchange rate regime? [6 Marks]

Or
How is foreign exchange rate determined? Explain with diagram.
Or [AI 2004; CBSE 06 q How is exchange rate determined in a foreign exchange market? Explain.[AI 2013 (Set 1)]

Answer:

1. Exchange rate in a free exchange market is determined at a point, where demand for foreign exchange is equal to the supply of foreign exchange.
2. Let us assume that there are two countries – India and U.S.A – and the exchange rate of their currencies i.e., rupee and dollar is to be determined.
Presently, there is floating or flexible exchange regime in both India and U.S.A. Therefore, the value of currency of each country in terms of the other currency depends upon the demand for and supply of their currencies.
3. In the above diagram, the price on the vertical axis is stated in terms of domestic currency (that is, how many rupees for one US dollar). The horizontal axis measures the quantity demanded or supplied.
4. In the above diagram, the demand curve [D\$] is downward sloping. This means that less foreign exchange is demanded as the exchange rate increases. This is due to the fact that the rise in price of foreign exchange increases the rupee cost of foreign goods, which make them more expensive. As a result, imports decline. Thus, the demand for foreign exchange also decreases.

The supply curve [S\$] is upward sloping which means that supply of foreign exchange increases as the exchange rate increases. This makes home country's goods become cheaper to foreigners since rupee is depreciating in value. The demand for our exports should therefore increase as the exchange rate increases. The increased demand for our exports translates into greater supply of foreign exchange. Thus, the supply of foreign exchange increases as the exchange rate increases.

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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5. The intersection of the supply and demand curves determine equilibrium exchange rate (OP\$) and equilibrium quantity [OQ\$] of foreign currency i.e., US [\$].

Question 2. Differentiate between devaluation and depreciation. [3 Marks]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 3. Are the concepts of demand for domestic goods and domestic demand for goods the same? [3 Marks]

Answer:

1. Demand for domestic goods and domestic demand for goods are two different concepts.
2. Demand for domestic goods is a demand for goods made by both domestic and foreign countries.
3. Domestic demand for goods is a demand for goods by our own country for goods ..which may be produced in foreign countries.

Question 4. Would the central bank need to intervene in a managed floating system? Explain why? [3 Marks]

Answer:

1. In a managed floating system a central bank of a country has freedom to bring change in the exchange rate within certain limits.
2. A country is allowed after information to the IMF to bring a certain limited amount of change in the rate of exchange.
3. A central bank cannot bring change in its exchange rate by more than 10%. For it, permission of IMF is necessary.

MORE QUESTIONS SOLVED

I. Very Short Answer Type Questions (1 Mark)

Question 1. What is foreign exchange?[CBSE AI 2011, 04]

Answer: Foreign exchange refers to all the currencies of the rest of the world other than the domestic currency of the country. For example, in India, US dollar is foreign exchange.

Question 2. What is meant by foreign exchange rate? [CBSE 2004,05,06,09 2011, Sample Paper 2010]

Answer: The rate at which one currency is exchanged for another is called foreign exchange rate.

Question 3. What is meant by foreign exchange market?

Answer: Foreign exchange market is the market where foreign currencies are bought and sold.

Question 4. Define flexible exchange rate system.[CBSE 2008]

Answer: Flexible exchange rate system refers to a system in which the exchange rate of different currencies is determined by the forces of demand and supply in foreign exchange market.

Question 5. The price of 1 US Dollar has fallen from Rs. 50 to Rs. 48. Has the Indian currency appreciated or depreciated?[CBSE Sample Paper 2010]

Answer: Indian currency has appreciated.

II. Multiple Choice Questions (1 Mark)

Question 1. Which function of foreign exchange market protects against the foreign

exchange risk?

- (a) Credit function
- (b) Hedging function
- (c) Transfer function
- (d) All of them

Answer: (b)

Question 2. Reduction in the value of domestic currency by the government is called

- (a) depreciation (b) devaluation
- (c) revaluation (d) appreciation

Answer: (b)

Question 3. Reduction in the value of domestic currency through market forces is called

-
- (a) depreciation (b) devaluation
 - (c) revaluation (d) appreciation

Answer: (a)

Question 4. Increase in the value of domestic currency by the government is called

- (a) depreciation (b) devaluation
- (c) revaluation (d) appreciation

Answer: (c)

Question 5. Increase in the value of domestic currency through market forces is called

- (a) depreciation (b) devaluation
- (c) revaluation (d) appreciation

Answer: (d)

Question 6. What will be the effect on exports if foreign exchange rate increases?

- (a) Increases (b) Decreases
- (c) Remains constant (d) None of them

Answer: (a)

Question 7. Foreign exchange is demanded by.....

- (a) domestic residents to purchase goods and services from other countries
- (b) sending gifts and grants to foreign countries (abroad)
- (c) the domestic residents to purchase financial assets in a particular country
- (d) all of them

Answer: (d)

Question 8. The supply of foreign exchange comes from.....

- (a) the foreigners purchasing home country's goods and services through exports
- (b) the foreigners who invest in home country through joint ventures or through financial market operations
- (c) currency dealers and speculators.
- (d) all of them

Answer: (d)

Question 9. Buyers and sellers of foreign exchange are _____ .

- (a) central banks
- (b) commercial banks
- (c) brokers (d) all of them

Answer: (d)

Question 10. Which exchange rate measures the average relative strength of a given currency with respect to other currencies without eliminating the effect of change in price?

- (a) Nominal exchange rate

- (b) Nominal effective exchange rate
- (c) Real exchange rate
- (d) Real effective exchange rate

Answer: (b)

Question 11. When one country manipulates exchange rate against the interest of other country, is known as

- (a) managed floating (b) dirty floating
- (c) wide band (d) crawling peg

Answer: (b)

Question 12. Other things remaining the unchanged, when in a country the price of foreign currency rises, national income is: (Choose the correct alternative) [CBSE Delhi 2015]

- (a) Likely to rise (b) Likely to fall
- (c) Likely to rise or to fall
- (d) Not affected

Answer: (a)

Question 13. Other things remaining the same, when in a country the market price of foreign currency falls, national income is likely: (Choose the correct alternative) [AT 2015]

- (a) to rise (b) to fall
- (c) to rise or to fall
- (d) to remain unaffected

Answer: (b)

Short Answer Type Questions (3-4 Marks)

Question 1. State four sources of demand of foreign exchange. [CBSE 2004, 05, 05C, 07; A 05, 10] Or

Give three reasons why people desire to have foreign exchange.

Or [CBSE 2005]

What are the sources of demand for foreign exchange?

Answer: The demand (or outflow) of foreign exchange comes from the people who need it to make payments in foreign currencies. It is demanded by the domestic residents for the following reasons:

1. **Imports of Goods and Services:** When India import goods and services, foreign exchange is demanded to make the payment for imports of goods and services.
2. **Tourism:** Foreign exchange is demanded to meet expenditure incurred in foreign tours.
3. **Unilateral Transfers sent abroad:** Foreign exchange is required for making unilateral transfers like sending gifts to other countries.
4. **Purchase of assets in foreign countries:** It is demanded to make payment for purchase of assets, like land, shares, bonds, etc. in foreign countries.

Question 2. What are the functions of a foreign exchange market?

Answer:

1. **Transfer Function:** Transfer function refers to transferring of purchasing power among countries.
2. **Credit Function:** It implies provision of credit in terms of foreign exchange for the export and import of goods and services across different countries of the world.
3. **Hedging Function:** Hedging function pertains to protecting against foreign exchange risks. Where Hedging is an activity which is designed to minimize the risk of loss.

Question 3. Why does demand for foreign exchange rise when its price falls?

Or [AI 2006, 08, 10] **What are the reasons for 'Rise in Demand' for Foreign Currency?**

Answer: The demand for foreign currency rises in the following situations:

1. When price of a foreign currency falls, imports from that, foreign, country become cheaper. So, imports increase and hence, the demand for foreign currency rises.
For example, if price of 1 US dollar falls from Rs 60 to T 55, then imports from The USA will increase as American goods will become relatively cheaper. It will raise the demand for US dollar.
2. When a foreign currency becomes cheaper in terms of the domestic currency, it promotes tourism to that country. As a result, demand for foreign currency rises.
3. When price of a foreign currency falls, its demand rises as more people want to make gains from speculative activities.

**Question 4. When price of a foreign currency rises, its demand falls'. Explain why?
Or [CBSE 2011]**

Explain relation between foreign exchange rate and demand for it.

Or [CBSE 2004q Why demand curve of foreign exchange is downward sloping?

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Answer:

1. Demand curve of foreign exchange slopes downwards due to inverse relationship between demand for foreign exchange and foreign exchange rate.
2. In figure, demand for foreign exchange (US dollar) and rate of foreign exchange are shown on the horizontal axis and vertical axis respectively.
3. The demand curve [US\$] is downward sloping. It means that less foreign exchange is demanded as the exchange rate increases.
4. This is due to the fact that rise in the price of foreign exchange increases the rupee cost of foreign goods, which make them more expensive. As a result, imports decline. Thus, the demand for foreign exchange also decreases.

Question 5. State four sources of supply of foreign exchange.[CBSE 2004, 05, 05C, 07, 10; AI 05] Or

What are the sources for supply of foreign exchange?

Answer: The supply (inflow) of foreign exchange comes from the people who receive it due to the following reasons.

1. **Exports of goods and services:** Supply of foreign exchange comes through exports of goods and services.
2. **Foreign investment:** The amount, which foreigners invest in their home country, increases the supply of foreign exchange.
3. **Remittances (unilateral transfers) from abroad:** Supply of foreign exchange increases in the form of gifts and other remittances from abroad.
4. **Speculation:** Supply of foreign exchange comes from those who want to speculate on the value of foreign exchange.

Question 6. What are the reasons of ‘rise in supply’ of foreign currency?

Or
Why does a rise in foreign exchange rate cause a rise in foreign exchange supply?
[CBSE 2006, 08]

Or
When exchange rate of a foreign currency rises, its supply also rises. How? Explain.
[CBSE 2008]

Answer: The supply of foreign currency rises in the following situations:

1. When price of a foreign currency rises, domestic goods become relatively cheaper. It induces the foreign country to increase their imports from the domestic country. As a result, supply of foreign currency rises. For example, if price of 1 US dollar rises from Rs 60 to Rs 65, then exports to USA will increase as Indian goods will become relatively cheaper. It will raise the supply of US dollars.
2. When price of a foreign currency rises, foreign direct investment (FDI) from rest of the world increases, which will increase the supply for foreign exchange.
3. When price of a foreign currency rises, also supply of foreign currency rises as people want to make gains from speculative activities.

Question 7. Why supply curve of foreign exchange is upward sloping?

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Answer:

1. Supply curve of foreign exchange slopes upwards due to positive relationship between supply for foreign exchange and foreign exchange rate, which means that supply of foreign exchange increases as the exchange rate increases.
2. This makes home country's goods become cheaper to foreigners since rupee is depreciating in value. The demand for our exports should therefore increase as the exchange rate increases.
3. The increased demand for our exports will translate into greater supply of foreign exchange. Thus, the supply of foreign exchange increases as the exchange rate increases.

Question 8. Explain the effect of depreciation of domestic currency on exports.

[A7 2013 (Set I), Sample Paper 2013]

Answer: Depreciation of domestic currency means a fall in the price of domestic currency (say, rupee) in terms of a foreign currency (say, \$). It means, with the same amount of dollars, more goods can be purchased from India, i.e., exports to USA will increase as they will become relatively cheaper.

Question 9. Explain the effect of appreciation of domestic currency on imports.

[CBSE 2013 (Set I), Sample Paper 2013)]

Answer: Appreciation of domestic currency means a rise in the price of domestic currency (say, rupee) in terms of a foreign currency (say, \$). Now, one rupee can be exchanged for more \$, i.e., with the same amount of money, more goods can be purchased from the USA. It leads to increase in imports from the USA as American goods will become relatively cheaper.

Question 10. What are the merits of fixed exchange rate system? [CBSE 2009]

Answer:

1. **Stability:** It ensures stability, in the international money market/ exchange market. Day to day fluctuations are avoided. It helps formulation of long term economic policies, particularly relating to exports and imports.
2. **Encourages international trade:** Fixed exchange rate system implies low risk and low uncertainty of future payments. It encourages international trade.
3. **Co-ordination of macro policies:** Fixed exchange rate helps co-ordination of macro policies across different countries of the world. Long term economic policies can be drawn in the area of international trade and bilateral trade agreements.

Question 11. What are merits of flexible exchange rate system? [CBSE, AI 2009]

Answer:

1. **No need for international reserves:** Flexible exchange rate system is not to be supported with international reserves.
2. **International capital movements:** Flexible exchange rate system enhances movement of capital across different countries of the world. This is due to the fact that member countries are no longer required to keep huge international reserves.
3. **Venture capital:** Flexible exchange rate promotes venture capital in foreign exchange market. Trading in international currencies itself becomes an important economic activity.

Question 12. Differentiate between fixed exchange rate and flexible exchange rate? [AI 2015]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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Question 13. Explain the meaning of Managed Floating Exchange Rate? [AI 2015]

Answer:

1. Managed floating exchange rate is a mixture of a flexible exchange rate (the float part) and a fixed exchange rate (the Managed part).
2. In other words, it refers to a system in which foreign exchange is determined by free market forces (demand and supply forces), which can be influenced by the invention of the central bank in foreign exchange market.
3. Under this system, also called Dirty floating, central banks intervene to buy or sell foreign currencies in an attempt to stabilise exchange rate movements in case of extreme appreciation or depreciation.

IV. True Or False

Are the following statements true or false? Give reasons.

Question 1. An increase in demand for imported goods raises the supply for foreign

exchange.

Answer: False. Supply of foreign exchange will decrease in order to make the payment for imported goods.

Question 2. Depreciation of Indian rupees will occur when Rs. 55 have to be paid to exchange one US \$ instead of present rate of Rs. 50/\$.

Answer: True. In case of depreciation, more rupees have to be paid to exchange one US dollar, i.e., greater than Rs. 50/\$.

Question 3. Appreciation of domestic currency leads to rise in imports.

Answer: True. Appreciation of domestic currency makes foreign goods relatively cheaper, which leads to increase in imports.

Question 4. Revaluation and appreciation of currency are one and the same thing.

Answer: False. Revaluation refers to increase in the value of domestic currency by the government under fixed exchange rate. On the other hand, currency appreciation refers to increase in the value of domestic currency in terms of foreign currency under flexible exchange rate system.

Question 5. In spot market sale and purchase of foreign currency is settled on a specified future date.

Answer: False. In spot market sale and purchase of foreign currency is settled immediately.

NOTE: As per CBSE guidelines, no marks will be given if reason to the answer is not explained..

V. Higher Order Thinking Skills

Question 1. Define pegging operations. [1 Mark]

Answer: Pegging operations refer to all efforts made by the central government to keep the rate of exchange stable.

Question 2. Define devaluation of currency. [1 Mark]

Answer: Devaluation refers to decrease in the value of domestic currency by the government. It is a part of fixed exchange rate.

Question 3. Define revaluation of currency.

Answer: Revaluation refers to increase in the value of domestic currency by the central government. It is a part of fixed exchange rate.

Question 4. Define Venture Capital. [1 Mark]

Answer: Venture capital in the international money market refers to investments in the purchase of foreign exchange in the international money market with a view to earning profits. Fixed exchange rate system discourages such investments.

Question 5. What is managed floating rate?[CBSE 2010] [1 Mark]

Answer: Managed floating exchange rate is a mixture of a flexible exchange rate (the float part) and a fixed exchange rate(the Managed part).

Question 6. Name the market exchange rate system in which a central bank can actively intervene.[Sample Paper 2013] [1 Mark]

Answer: Managed Floating Exchange rate.

Question 7. Differentiate between Currency Depreciation and Currency Appreciation.[3 Marks]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

VI. Value Based Questions

Question 1. Do you think that a rise in BPO services a good source of supply of foreign currency? [1 Mark]

Answer: Yes, because it is a export of services and good source of foreign currency.

Value: Critical Thinking

Question 2. Suppose the present foreign exchange rate is 1\$ = Rs 50 and if it rises to 1\$ = Rs 60 should central bank intervene in the foreign exchange rate? [1 Mark]

Answer: Yes, Central Bank should intervene in order to safeguard the interest of the importers.

Value: Creative Thinking

Question 3. What impact will fall on the expenditure of an American citizen who comes to India for Medical treatment if foreign rate is increased? [1 Mark]

Answer: Expenditure on treatment will reduce because by the increasing foreign exchange rate, his purchasing power will increase.

Value: Empathy

Question 4. Why did India devalue its currency in 1991? [1 Mark]

Answer: India devalued its currency in 1991 to increase the flow of foreign exchange reserve.

Value: analytic

VII. Application Based Questions

Question 1. How can Reserve- Bank of India help in bringing down the foreign exchange rate which is very high?[AI 2013 (Set 1)] [1 Mark]

Answer: Reserve Bank of India can start selling the foreign currency from its reserves to increase its supply.

Question 2. What is the role of a Central Bank in the following exchange rate?[3 Marks]

(a) Fixed exchange

(b) Floating exchange

(c) Managed floating [CBSE Sample Paper 2014]

Answer: The role of the Central Bank in maintaining the foreign exchange rates under different regimes is:

1. **Fixed exchange rate system:** A Central Bank actively uses its foreign currency reserves to maintain the officially determined exchange rate.
2. **Floating exchange rate system:**A Central Bank does not maintain any reserves of foreign currency as the market automatically adjusts to determine the market driven exchange rate
3. **Managed Floating:** A Central Bank enters the foreign exchange market to buy/sell foreign currency in order to control fluctuations and volatility in the market.

Question 3. 'Devaluation and Depreciation of currency are one and the same thing'. Do you agree?

How do they affect the exports of a country? [CBSE Sample Paper 2016] [3 Marks]

Answer:

1. Devaluation refers to reduction in price of domestic currency in terms of all foreign currencies under fixed exchange rate regime, i.e., (It takes place due to government) .
2. Depreciation refers to fall in market price of domestic currency in terms of a foreign currency under flexible exchange rate regime, i.e., (It takes place due to market forces of demand and supply)
3. Currency Depreciation and Currency Devaluation may result into increase in exports of the goods and services from the country since it would increase the global competitiveness of the goods.



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**Question 1. Differentiate between Balance of Trade and Current Account Balance.
[3 Marks] Or**

**Distinguish between BOT and Balance on current account. [AI 2008, CBSE 2013,
Sample Paper 2013]**

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 2. Should a current account deficit be a cause for alarm? Explain. [1 Mark]

Answer: No, if deficit in current account is offset by the capital account, otherwise such deficit has to be met by following which is a cause for alarm.

1. Depleting Foreign Exchange reserves
2. Taking foreign Loans.

Value: Analytic.

Question 3. If inflation is higher in country A than in country B, and the exchange rate between the two countries is fixed. What is likely to happen to the trade balance between the two countries? [1 Mark]

Answer: The exports from country B to country A will go up in this situation resulting in improvement or surplus trade balance for B. But due to higher price in country A, its imports will increase for country B and it will lead to deficit in trade balance for country A.

MORE QUESTIONS SOLVED

I. Very Short Answer Type Questions (1 Mark)

Question 1. What does balance of payments account of a country record? [CBSE 2007]

Answer: Balance of payments is an accounting statement that provides a systematic record of all the economic transactions between the residents of a country and the rest of the world during a given period of time.

Question 2. What is meant by visible items?

Answer: Visible items include material goods [such as sugar, cloth, machines etc.] which can be seen or touched, counted, measured and weighted and which are duly recorded at the custom barriers.

Question 3. What is the meaning of invisible items?

Answer: Invisible items, on the other hand, refer to different kinds of services such as transport, banking, insurance etc.

Question 4. Why are imports entered as negative items in the balance of payments account?

Answer: Imports lead to an outflow of foreign exchange in the country. Thus, they are recorded as negative (debit) items.

Question 5. What is meant by balance of trade? [CBSE 2005, Sample Paper 2010]

Answer: The term "balance of trade" denotes the difference between the exports and imports of goods in a country.

Question 6. Name the items included in balance of trade account. [CBSE 2007]

Answer:

1. Exports of visible items (goods);

2. Imports of visible items (goods).

Question 7. When will balance of trade show a deficit? [CBSE 2006]

Answer: When imports of visible items are more than exports of visible items.

Question 8. How is a deficit or a surplus on the current account restored?

Answer: Deficit on the current account is restored through the surplus on capital account and surplus on the current account is restored through the deficit on capital account.

II. Multiple Choice Questions (1 Mark)

Question 1. ————— is a systematic record of all the economic transactions between one country and rest of the world.

- (a) Balance of trade**
- (b) Balance of transactions**
- (c) Budget**
- (d) Balance of payments**

Answer: (d)

Question 2. If India exports goods worth Rs 20 crore and imports goods worth Rs 30 crore, it will have a————.

- (a) surplus of Rs 10 crore in balance of trade**
- (b) deficit of Rs 10 crore in balance of trade**
- (c) deficit of ? 50 crore in balance of trade**
- (d) can't say**

Answer: (b)

Question 3. Which one of the following items is an intangible item in balance of payments statement?

- (a) Export of food grains**
- (b) Import of crude oil**
- (c) Banking services provided in other countries**
- (d) Import of steel by steel industry**

Answer: (c)

Question 4. Which one of the following statements deals with debts and claims of a country?

- (a) Balance of capital account**
- (b) Balance of trade account**
- (c) Balance of current account**
- (d) Balance of services**

Answer: (a)

Question 5. Name the economic transactions which are undertaken to make equilibrium in balance of payment,

- (a) Autonomous items**
- (b) Accommodating items**
- (c) Invisible items**
- (d) None of them**

Answer: (b)

Question 6. Current account of BOP records transactions is relating to————.

- (a) exchange of goods**
- (b) exchange of services**
- (c) unilateral transfers**
- (d) all of them**

Answer: (d)

Question 7. Current transactions are of————.nature.

- (a) flow**

- (b) stock
- (c) both flow and stock
- (d) none of the above

Answer: (a)

Question 8. Capital account may be -----.

- (a) private capital
- (b) banking capital
- (c) official capital
- (d) all of them

Answer: (d)

III.Short Answer Type Questions (3-4 Marks)

Question 1. State four items of current account of BOP account.[CBSE 2004, 08, 08C, 09; AI 05]

Or

Name the broad categories of transactions recorded in the Current account of the balance of payment accounts. [CBSE 2015]

Answer: Current account records imports and exports of goods and services and unilateral transfers. Components of Current Account The main components of Current Account are:

1. Export and Import of Goods (Merchandise Transactions or Visible Trade): A major part of transactions in foreign trade is in the form of export and import of goods (visible items). Payment for import of goods is written on the negative side (debit items) and receipt from exports is shown on the positive side (credit items). Balance of these visible exports and imports is known as balance of trade (or trade balance).
2. Export and Import of Services (Invisible Trade): It includes a large variety of non-factor services (known as invisible items) sold and purchased by the residents of a country, to and from the rest of the world. Payments are either received or made to the other countries for use of these services. Services are generally of three kinds: (a) Shipping, (b) Banking, and (c) Insurance. Payments for these services are recorded on the negative side and receipts on the positive side.
3. Unilateral or Unrequited Transfers to and from abroad (One sided Transactions): Unilateral transfers include gifts, donations, personal remittances and other 'one-way' transactions. These refer to those receipts and payments, which take place without any service in return. Receipt of unilateral transfers from rest of the world is shown on the credit side and unilateral transfers to rest of the world on the debit side.
4. Income receipts and payments to and from abroad: It includes investment income in the form of interest, rent and profits.

Question 2. What do you mean by capital account and what are its components?

Or

State four items (components) of capital account of BOP account.[CBSE 2004, 11, AI 05]

Or

Name the broad categories of transactions recorded in the Capital account of the balance of payment accounts. [CBSE 2015]

Answer: Capital account is that account which records all such transactions between residents of a country and rest of the world which cause a change in the asset or liability status of the residents of a country or its government.

Components of Capital Account

The main components of capital account are:

1. Loans: Borrowing and lending of funds are divided into two transactions:
 - (a) Private Transactions

- These are transactions that are affecting assets or liabilities by individuals, businesses, etc. and other non-government entities. The bulk of foreign investment is private.
- For example, all transactions relating to borrowings from abroad by private sector and similarly repayment of loans by foreigners are recorded on the positive (credit) side.
- All transactions of lending to abroad by private sector and similarly repayment of loans to abroad by private sector is recorded as negative or debit item.

(b) Official Transactions

- Transactions affecting assets and liabilities by the government and its agencies.
- For example, all transactions relating to borrowings from abroad by government sector and similarly repayment of loans by foreign government are recorded on the positive (credit) side.
- All transactions of lending to abroad by government sector and similarly repayment of loans to abroad by government sector is recorded as negative or debit item.

2. Foreign Investment (Investments to and from abroad) It includes:

(a) Investments by rest of the world in shares of Indian companies, real estate in India, etc. Such investments from abroad are recorded on the positive (credit) side as they bring in foreign exchange.

(b) Investments by Indian residents in shares of foreign companies, real estate abroad, etc. Such investments to abroad are recorded on the negative (debit) side as they lead to outflow of foreign exchange.

3. Change in Foreign Exchange Reserves

(a) The foreign exchange reserves are. the financial assets of the government held in central bank. A change in reserves serves as the financing item in India's BOP.

(b) So, any withdrawal from the reserves is recorded on the positive (credit) side and any addition to these reserves is recorded on the negative (debit) side.

(c) It must be noted that 'change in reserves' is recorded in the BOP account and not 'reserves'.

Question 3. Distinguish between current account and capital account of BOP account. [AI 2004, 06 C]

Answer:

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Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 4. Distinguish between balance of trade and balance of payment. [AI 2004, 06C]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

Question 5. Distinguish between autonomous and accommodating transactions of BOP account. ” [AI 2010; CBSE 10, 13C]

Answer:

Four factors of Production	Remuneration Paid
Land	Rent
Labour	Wages
Capital	Interest
Enterprise	Profit

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Question 6. Where is 'borrowings from abroad' recorded in the Balance of Payments Accounts? Give reasons. [AT 2015]

Answer:

- Borrowing from abroad is a part of Capital Account.
- Borrowing from abroad can be private transactions or official transactions.
- For example,
 - All transactions relating to borrowings from abroad by private sector are recorded on the positive (credit) side as it is inflow of foreign currency.
 - Similarly, transactions relating to borrowings from abroad by government sector are recorded on the positive (credit) side as it is inflow of foreign currency.

Question 7. Where will sale of machinery to abroad be recorded in the balance of payment accounts? Give reasons. [CBSE 2015]

Answer:

- Sale of machinery to abroad is a part of Current accounts.
- Current account records imports and exports of goods and services and unilateral transfers.

3. Sale of machinery to abroad leads to inflow of foreign currency and receipt from exports is shown on the positive side (credit items).

Question 8. What is meant by 'official reserve transactions'? Discuss their importance in Balance of Payments.[CBSE Sample Paper 2016]

Answer:

1. Official reserve transactions are those transactions by a central bank that cause changes in its official reserves.
2. It is sale or purchase of its own currency in the exchange market in exchange for foreign currencies.
3. So, any withdrawal from the reserves is recorded on the positive (Credit) side and any addition to these reserves is recorded on the negative (debit) side.
4. They may be Autonomous and Accommodating Transactions.

IV. True Or False

Giving reasons, state whether the following statements are true or false.

Question 1. In balance of payments, repayment of loans by Indian Government to American Government will be reflected as debit item.

Answer: True. It is so because it leads to outflow of foreign exchange.

Question 2. Accommodating items of trade are undertaken in order to maintain the balance in the BOP account.

Answer: True. Accommodating transactions are net consequences of autonomous transactions that are undertaken to correct disequilibrium in autonomous items of BOP.

Question 3. Excess of foreign exchange payments on account of accommodating transactions equals deficit in BOP.[CBSE 2011]

Answer: False. Excess of foreign exchange payments on account of autonomous transactions equals deficit in BOP.

Question 4. Export and import of machines are recorded in capital account of BOP account. [CBSE 2011]

Answer: False. Export and import of machines are considered as export and import of goods, that comes under current account of BOP account.

Question 5. Foreign exchange received on account of export of sugar will be X'ecorded in current account.

Answer: True. It is so because export of sugar is a export of goods which is a component of current account.

Question 6. Accommodating items are also known as 'above the line' items.

Answer: False. Accommodating items are also known as 'below the line' items. (Autonomous items are also known as 'above the line' items.)

Question 7. Unilateral transfers received from abroad will be recorded as a credit item of BOP on current account.

Answer: True. It leads to inflow of foreign exchange.

Question 8. Borrowing by government from World Bank to finance the BOP deficit will be recorded in the capital account.

Answer: True. Borrowing by the government is a accommodating transaction and it is recorded in the capital account only.

Question 9. Autonomous transactions take place in current account only.

Answer. False. Autonomous transactions take place in both current and capital accounts.

Note: As per CBSE guidelines, no marks will be given if reason to the answer is not explained.

V. Higher Order Thinking Skills

Question 1. What does deficit in a current account indicate? [1 Mark]

Answer: A deficit in a current account indicates that the inflow of foreign currencies from exports of

goods and services is less than the outflow of foreign currencies on account of import of goods and services.

Question 2. What does deficit in capital accounts indicate? [1 Mark]

Answer: A deficit in capital accounts indicates that the inflow of foreign currencies by purchase of an assets by a foreign country in home country is less than the outflow of foreign currencies on account of purchase of assets abroad by home country.

Question 3. Explain the meaning of deficit in BOP. [CBSE 2010, AI 13] [3-4 Marks]

Answer:

1. The balance of payments of a country is a systematic record of all economic transactions between the residents of foreign countries during a given period of time.
2. The transaction in the balance of payment account can be categorized as autonomous transactions and accommodating transactions.
3. Autonomous transactions are transactions done for some economic consideration such as profit.
4. When the total inflows on account of autonomous transactions are less than total outflows on account of such transactions, there is a deficit in the balance of payments account.
5. Suppose, the autonomous inflow of foreign exchange during the year is \$500, while the total outflow is \$600. It means that there is a deficit of \$100.

Question 4. The balance of trade shows a deficit of Rs 5,000 crore and the value of imports are Rs 9,000 crore. What is the value of exports? [CBSE 2004] [3 Marks]

Answer: Balance of Trade = -Rs 5,000 crore Value of Imports = Rs 9,000 crore Balance of trade (Deficit) = Value of Exports – Imports Value of Exports = Balance of trade (Deficit) + Imports = -Rs 5,000 crore + Rs 9,000 crore = Rs 4,000 crore

Question 5. The balance of trade shows a deficit of Rs 300 crore. The value of exports is Rs 500 crore. What is the value of imports? [CBSE 2004][3 Marks]

Answer: Balance of Trade = -Rs 300 crore Value of exports = Rs 500 crore Balance of trade (Deficit) = Value of Exports – Imports Imports = Exports – Balance of trade ((deficit) = Rs 500 crore – (-Rs 300 crore) = Rs 800 crore

VI. Application Based Questions

Question 1. How can increase in foreign direct investment affect the price of foreign exchange? [CBSE 2013 (Set I)][1 Mark]

Answer: Increase in foreign direct investment can affect the price of foreign exchange because increase in foreign direct investment raises the supply of foreign exchange that lowers the price of foreign exchange.

Question 2. State whether the following transactions will be recorded on debit or credit side of BOP. [3-4 Marks]

1. **Loan from IMF to cover deficit of BOP.**
2. **Indian Government repays loan taken from IMF.**
3. **Purchase of shares of Infosys by a Japanese resident.**
4. **Export of Jute to Sri Lanka.**
5. **Acquisition of a foreign company by Tata.**
6. **Purchase of toys from China.**

Answer: Transactions relating to inflow of foreign exchange will be recorded on the credit side and outflows of foreign exchange on the debit side. Debit Side: (2), (5), (6); and Credit Side: (1), (3), (4).

Question 3. Identify the following items as visible items or invisible items. [3-4 Marks]

1. **Export of computer software**
2. **Import of LCD screen from Malaysia**
3. **Banking service to NRI**
4. **Export of Tea to Thailand**

5. Consultancy services of TCS used by a foreign firm

Answer: Visible Items: (2), (4); Invisible Items: (1), (3), (5).

Question 4. Classify whether the following transactions will be recorded in current account or capital account. [3-4 Marks]

- 1. Purchase of shares of Tata by Microsoft.**
- 2. Imports of computer spare parts from America.**
- 3. Borrowings from World Bank.**
- 4. Repayment of loan by Indian Government taken from Japan.**
- 5. Gifts received from a relative in Australia.**
- 6. Purchase of Land in China.**
- 7. Import of machinery.**

Answer: Current Account: (2), (5), (7); Capital Account: (1), (3), (4), (6).

