SYLLABUS

Semester V

ECODSM – 301/302

Principles of Macroeconomics

Unit 1: Money

Money: Types and Functions; Quantity Theory of Money, Determinants of Money Supply,

Measures of Money Supply, Demand for Money: Keynesian Liquidity Preference Theory.

Unit 2: Banking and Monetary Policy

Central Bank: Functions and Role; Commercial Banks: Functions, Role and Credit Creation,

Credit Control Measures, Monetary Policy: Definition, Objectives, Instruments and Role.

Unit 3: Determination of Income and Employment

Aggregate Demand and Aggregate Supply, Simple Keynesian Model: Consumption Function,

Savings and Investment Functions; Determination of Equilibrium Output, Concept of Multiplier,

Classical Theory of Employment, Say's law of Market.

Unit 4: Inflation and Unemployment

Inflation: Meaning, Cost Push and Demand Pull Inflation, Effects of Inflation, Control of Inflation,

Unemployment: Measurement and Types; Phillip's Curve: Short run and Long run, Stagflation.

Unit 5: Open Economy

Balance of Payments: Current Account and Capital Account, Balance of Trade, Disequilibrium in

BOP: Causes and Correction, Foreign Exchange Rate: Meaning and Types, Determination of

Equilibrium Exchange Rate.

UNIT – 1

ONE MARK:

1. What is money?
Money is anything that is generally accepted as a medium of exchange.

2. Who defined money as "what money does, money is"?
Walker.

3. Mention one primary function of money.
Medium of exchange.

4. What are the two main types of money?
Commodity money and fiat money.

5. What is commodity money?
Money made of valuable commodities like gold or silver.

6. What is fiat money?
Money issued by government authority without intrinsic value, such as paper currency.

7. Give an example of near money.
Bank deposits.

8. What is token money?
Money whose face value is greater than its intrinsic value, e.g., ₹10 coin.

9. Who gave the Quantity Theory of Money?
Irving Fisher.

10. State Fisher's Equation of Exchange.
MV = PT.

11. In Fisher's equation, what does M stand for?
Quantity of money.

12. In Fisher's equation, what does V stand for?
Velocity of money circulation.

13. What does T denote in Fisher's equation?
Volume of transactions.

14. According to Keynes, demand for money is also called what?
Liquidity preference.

15. What are the three motives of liquidity preference given by Keynes?
Transaction motive, precautionary motive, and speculative motive.

16. Which motive of demand for money is related to uncertainty?
Precautionary motive.

17. Which motive of demand for money is influenced by the rate of interest?
Speculative motive.

18. Define money supply.
Money supply is the total stock of money available in the economy at a given time.

19. Mention one determinant of money supply.
Central bank policies.

20. What is M1 measure of money supply in India?
Currency with public + demand deposits + other deposits with RBI.

21. What is M2 measure of money supply?
M1 + savings deposits with post office savings banks.

22. What is M3 measure of money supply?
M1 + time deposits with banks.

23. What is M4 measure of money supply?
M3 + total deposits with post office savings organizations.

24. Which institution controls the money supply in India?
Reserve Bank of India (RBI).

25. What is the standard definition of money supply in India?
M3 is considered the standard measure of money supply.

26. Who introduced the concept of liquidity preference?
J. M. Keynes.

27. Which function of money removes the difficulty of double coincidence of wants?
Medium of exchange.

28. Which function of money helps in measuring value of goods?
Unit of account.

29. Which function of money allows wealth to be stored for future use?
Store of value.

30. Which function of money is used for repayment of debts?
Standard of deferred payments.

TWO MARK:

1. Define money and its importance.
Money is a medium of exchange that facilitates trade by eliminating the problem of barter. It is important because it acts as a unit of account, store of value, and standard of deferred payments.

2. What are the primary functions of money?
The two main primary functions are: (i) medium of exchange, and (ii) measure of value (unit of account). These functions make money universally accepted in trade.

3. What are the secondary functions of money?
The secondary functions include store of value, standard of deferred payment, and transfer of value. These functions strengthen money's role in economic activities.

4. What is commodity money? Give example.
Commodity money refers to money that has its own intrinsic value, such as gold, silver, or salt. For example, in earlier times, gold coins were used as money.

5. What is fiat money?
Fiat money has no intrinsic value but is declared legal tender by the government. For instance, paper currency notes issued by the Reserve Bank of India.

6. What is token money?
Token money is money whose face value is higher than its intrinsic value. For example, a ₹10 coin may cost less than ₹2 to produce.

7. Explain near money with an example.
Near money refers to assets that are not actual money but can be quickly converted into cash. Examples are fixed deposits and treasury bills.

8. What is the Quantity Theory of Money?
The Quantity Theory of Money states that the general price level is directly proportional to the supply of money, if velocity of circulation and volume of transactions are constant. Fisher expressed it through $MV = PT$.
(Diagram: Flow chart of $MV = PT$)

9. Who gave the equation of exchange and what is it?
Irving Fisher proposed the equation of exchange: MV = PT. Here M is money supply, V is velocity, P is price level, and T is transactions.

10. What is the cash balance approach to Quantity Theory of Money?
The cash balance approach, given by Cambridge economists, explains money demand as a proportion of income people wish to hold in cash. It is expressed as M = kPY.

11. Mention two determinants of money supply.
The money supply is influenced mainly by the policies of the Reserve Bank of India and commercial banks' credit creation. Fiscal policy of the government also plays a role.

12. What are the measures of money supply in India?
According to RBI, money supply is measured as M1, M2, M3, and M4. Among these, M3 is considered the most standard measure in India.

13. What is M1 in money supply?
M1 includes currency with the public, demand deposits with banks, and other deposits with RBI. It is the narrowest measure of money supply.

14. What is M2 in money supply?
M2 consists of M1 plus savings deposits with post office savings banks. It is slightly broader than M1.

15. What is M3 in money supply?
M3 includes M1 plus time deposits with banks. It is the most commonly used measure of money supply in India.

16. What is M4 in money supply?
M4 includes M3 plus total deposits with post office savings organizations. It is the broadest measure of money supply.

17. Which institution regulates money supply in India?
The Reserve Bank of India (RBI) regulates money supply through monetary policy, credit control, and issue of currency.

18. Define demand for money.
Demand for money refers to the desire to hold wealth in the form of liquid cash rather than other assets like bonds or goods.

19. What is Keynes' Liquidity Preference Theory?
Keynes explained demand for money through liquidity preference, which means the preference of individuals to hold their wealth in cash.

20. What are the three motives of liquidity preference?
The three motives are transaction motive (day-to-day expenses), precautionary motive (uncertainties), and speculative motive (investment opportunities).

21. Explain the transaction motive of demand for money.
Transaction motive refers to holding money for meeting daily business and household transactions. It is directly related to the level of income.

22. Explain the precautionary motive of demand for money.
Precautionary motive refers to holding cash for unforeseen situations like illness or accidents. It is influenced by income levels.

23. Explain the speculative motive of demand for money.
Speculative motive refers to holding cash to take advantage of future changes in interest rates and bond prices. It is highly interest-sensitive.
(Diagram: Downward sloping Liquidity Preference Curve)

24. How is demand for money related to rate of interest?
According to Keynes, demand for speculative money is inversely related to the rate of interest. When interest rates are high, people prefer bonds; when low, they prefer cash.

25. What is meant by velocity of money?
Velocity of money refers to the number of times a unit of currency circulates in an economy to purchase goods and services within a given time period.

26. What is the difference between high-powered money and money supply?
High-powered money (H) is the base money created by RBI, while money supply (M) includes H plus the credit created by commercial banks.

27. What is credit money?
Credit money is money accepted as a medium of exchange on the basis of trust, such as cheques, drafts, and bills of exchange.

28. What is legal tender money?
Legal tender money is money that is legally recognized for repayment of debts. In India, currency notes and coins are legal tender.

29. What is the standard measure of money supply in India?
M3 is considered the standard and most commonly used measure of money supply in India.

30. What is the role of RBI in controlling money supply?
The RBI controls money supply by using monetary policy instruments such as Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR), and Repo Rate.

BOARD ANSWER:

Q1. Define Money. Discuss its types and functions.

Introduction
Money is one of the most important inventions in the history of human civilization. In simple terms, money is anything that is generally accepted as a medium of exchange, measure of value, store of value, and standard of deferred payments. Without money, exchange would be limited to barter, which suffers from several difficulties such as the lack of double coincidence of wants. The evolution of money has made trade easier and economies more organized.

Types of Money

1. **Commodity Money**: This is money that has intrinsic value. Commodities like gold, silver, and copper were used as money in the past.
2. **Fiat Money**: Money issued by government authority without intrinsic value but declared as legal tender. For example, paper currency notes in India.
3. **Token Money**: Money whose face value is greater than its intrinsic value. Example: ₹10 coin.
4. **Near Money**: Assets that can be easily converted into cash, such as bank deposits, treasury bills, etc.
5. **Credit Money**: Money based on trust, e.g., cheques, promissory notes, bills of exchange.
6. **Legal Tender Money**: Money which must be accepted by law for repayment of debts.

Functions of Money

1. **Primary Functions**
   - Medium of Exchange: Money facilitates transactions by removing the problem of barter.
   - Measure of Value: It provides a common unit to measure and compare values of goods and services.

2. **Secondary Functions**
   - Store of Value: Wealth can be stored in the form of money and used in the future.
   - Standard of Deferred Payments: Contracts and debts can be expressed in terms of money for future payments.
   - Transfer of Value: Money enables transfer of value from one place or person to another.
3. **Contingent Functions**
   - Basis of credit system.
   - Helps in capital formation.
   - Facilitates maximum utilization of resources.

Conclusion
Money has become the lifeblood of modern economies. Its functions are essential for trade, production, investment, and development. Over time, money has evolved from commodity forms to modern electronic money, but its core functions remain the same.

Q2. Explain the Quantity Theory of Money. Discuss Fisher's version with the equation of exchange.

Introduction
The Quantity Theory of Money is a classical theory which explains the relationship between money supply and the price level in an economy. It assumes that other things remain constant, an increase in the quantity of money will lead to a proportional increase in the price level.

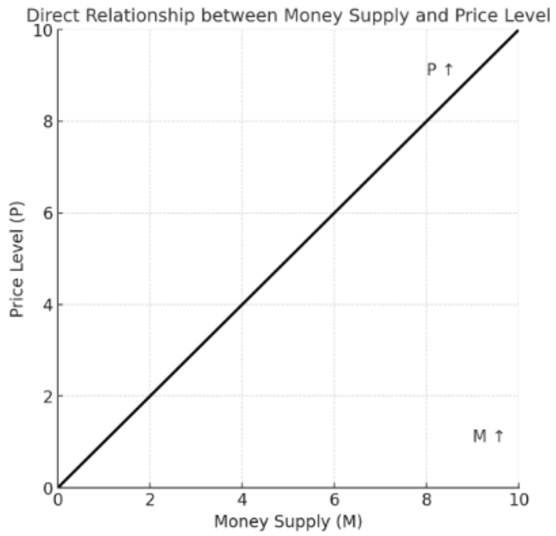
Fisher's Version
Irving Fisher presented the **Equation of Exchange**:
MV = PT

Where,
M = Quantity of Money
V = Velocity of circulation of money
P = Price level
T = Volume of transactions

Explanation
According to Fisher, the total money spent (MV) must equal the total value of goods and services transacted (PT). Thus, price level (P) depends directly on the supply of money (M) if V and T are constant.

Assumptions of Fisher's Theory

1. Full employment in the economy.
2. Velocity of money (V) is constant.
3. Volume of transactions (T) is constant.
4. Money is only a medium of exchange.



Criticism

1. Assumes full employment, which is unrealistic.
2. Ignores the role of interest rates.
3. Ignores demand for money for speculative purposes.
4. Keynes criticized it as an incomplete theory.

Conclusion
Fisher's Quantity Theory of Money was a foundation for monetary economics. Though criticized, it highlighted the importance of money supply in determining the price level. Later economists, especially Keynes, refined it by including demand for money and interest rates.

Q3. Discuss the determinants and measures of money supply in India.

Introduction
Money supply is the total stock of money available in the economy at a given time. It includes both currency and deposits that are readily available for transactions. In India, the Reserve Bank of India (RBI) plays a central role in controlling money supply.

Determinants of Money Supply

1. **High-powered money (H)**: Currency issued by RBI and reserves of commercial banks.
2. **Monetary Policy of RBI**: Use of CRR, SLR, repo rate, etc.
3. **Credit creation by commercial banks**: Through lending, banks expand the money supply.
4. **Government Fiscal Policy**: Deficit financing, borrowing, and spending influence money supply.
5. **Public's preference for cash or deposits**: If people hold more cash, credit creation reduces.

Measures of Money Supply (RBI Classification)

- **M1 (Narrow Money)**: Currency with the public + demand deposits with banks + other deposits with RBI.
- **M2**: M1 + savings deposits with post office savings banks.
- **M3 (Broad Money)**: M1 + time deposits with banks. (This is the standard measure).
- **M4**: M3 + total deposits with post office savings organizations.

Conclusion
Money supply is a vital component of the economy that affects inflation, investment, and growth. In India, M3 is considered the most important measure, and the RBI continuously monitors and controls it to ensure stability.

Q4. Explain Keynes' Liquidity Preference Theory of demand for money.

Introduction
Keynes criticized the classical theory of money and developed the Liquidity Preference Theory, which explains why people demand money. According to

him, money is demanded not just for transactions but also due to precaution and speculation.

Three Motives of Liquidity Preference

1. **Transaction Motive**: People hold money for day-to-day transactions. The amount depends on income.
2. **Precautionary Motive**: People hold extra cash to meet unexpected needs such as illness, accidents, or emergencies.
3. **Speculative Motive**: People hold money to take advantage of changes in interest rates and bond prices. This motive is interest-sensitive.

Relationship with Interest Rate

Speculative demand for money is inversely related to the rate of interest. When interest rates are high, people invest in bonds; when rates are low, they hold money.

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Interest Rate (r)
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   |   \
   |    \
   |     \
   |      \
   |       \   L (Liquidity Preference Curve)
   |        \
   |         \
   |___________________________ Money Demand (M)
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👉 Explanation:

- The **Y-axis** represents the **rate of interest (r)**.
- The **X-axis** represents the **demand for money (M)**.
- The **downward sloping curve (L)** shows that when the **interest rate is high**, people prefer to hold less money (because they earn more by saving/investing).
- When the **interest rate falls**, the **demand for money increases** since the opportunity cost of holding money is low.

Criticism

1. Overemphasis on interest rates.
2. Ignores real factors like income and output.
3. Cannot explain inflationary situations fully.

Conclusion
Keynes' theory marked a turning point in monetary economics. By including motives and interest rates, it provided a more realistic explanation of money demand than the classical theories.

Q5. What are the functions of the Reserve Bank of India in controlling money supply?

Introduction
The Reserve Bank of India (RBI) is the central bank of India, established in 1935. Its primary function is to regulate money supply, maintain price stability, and promote economic growth.

Functions of RBI in Controlling Money Supply

1. **Quantitative Measures**
   - **CRR (Cash Reserve Ratio):** Portion of deposits banks must keep with RBI.
   - **SLR (Statutory Liquidity Ratio):** Portion of deposits banks must keep in liquid assets.
   - **Repo Rate:** Interest charged by RBI on short-term loans to banks.
   - **Reverse Repo Rate:** Rate at which RBI borrows money from banks.
   - **Open Market Operations:** Buying and selling government securities.
2. **Qualitative Measures**
   - Credit rationing.
   - Directives to banks about lending to priority sectors.
   - Margin requirements on loans.

Conclusion
The RBI plays a central role in India's monetary system. By controlling money supply, it maintains balance between inflation and growth, ensuring financial stability in the economy.

Q6. Explain the relationship between money supply, price level, and inflation.

Introduction
Money supply and price level are closely related. Economists argue that inflation is largely a monetary phenomenon. When money supply increases beyond productive capacity, it results in rising prices.

Money Supply and Price Level
According to the Quantity Theory of Money, price level (P) is directly proportional to money supply (M), if other factors remain constant. An excessive money supply causes too much money chasing too few goods, leading to inflation.

Inflation and its Types

1. **Demand-Pull Inflation**: Caused by excess demand due to increased money supply.
2. **Cost-Push Inflation**: Caused by increased cost of production, not directly linked to money supply.

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P |                  /
  |                /
  |              /
  |            /
  |          /
  |        /
  |_______/__________ M
       Money Supply (M)
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- The **X-axis** represents *Money Supply (M)*.
- The **Y-axis** represents *Price Level (P)*.
- The line is an **upward-sloping straight line**, showing that as Money Supply increases, Price Level also increases.

Role of Monetary Policy
RBI controls inflation by reducing money supply using measures like higher CRR, SLR, repo rate, and selling government securities.

Conclusion
The relationship between money supply and inflation is vital for economic

stability. A moderate increase in money supply promotes growth, but excessive increase causes inflation. Thus, proper control of money supply is necessary.

UNIT – 2

ONE MARK:

Q1. Who is the Central Bank of India?
Ans: The Reserve Bank of India (RBI).

Q2. In which year RBI was established?
Ans: 1935.

Q3. Who is known as the 'Lender of Last Resort'?
Ans: The Central Bank.

Q4. Define Monetary Policy.
Ans: Monetary policy refers to the regulation of money supply and credit in the economy by the Central Bank.

Q5. What is CRR?
Ans: Cash Reserve Ratio – the percentage of deposits that commercial banks must keep with RBI.

Q6. What is SLR?
Ans: Statutory Liquidity Ratio – the percentage of deposits that banks must keep in the form of liquid assets like cash, gold, or approved securities.

Q7. Give one function of Commercial Banks.
Ans: Accepting deposits.

Q8. What is Repo Rate?
Ans: The rate at which the RBI lends money to commercial banks.

Q9. What is Reverse Repo Rate?
Ans: The rate at which RBI borrows money from commercial banks.

Q10. State one objective of Monetary Policy.
Ans: To control inflation.

Part B – Two Mark Questions (10 Qs)

(Slightly descriptive but short answers)

Q11. What are the two types of functions of the Central Bank?
Ans: (i) Traditional functions (issue of currency, lender of last resort, control of credit).

(ii) Developmental functions (promotion of banking, agriculture, industries, etc.).

Q12. Explain the role of Commercial Banks in economic development.
Ans: They mobilize savings, provide credit to industries, agriculture, and trade, and promote investment and growth.

Q13. What is Credit Creation by Commercial Banks?
Ans: It is the process by which banks create more credit (loans) than the actual cash deposits they hold through fractional reserve banking.

Q14. Mention any two credit control measures of RBI.
Ans: (i) Quantitative methods – CRR, SLR, Repo rate.
(ii) Qualitative methods – credit rationing, margin requirements.

Q15. Define Open Market Operations.
Ans: It refers to the buying and selling of government securities by the RBI to control money supply.

Q16. Distinguish between Quantitative and Qualitative credit control.
Ans: Quantitative controls regulate the total volume of credit, while qualitative controls regulate the purpose and direction of credit.

Q17. What is the difference between Repo Rate and Reverse Repo Rate?
Ans: Repo rate is charged when banks borrow from RBI, Reverse repo rate is what banks earn by lending to RBI.

Q18. What is the meaning of Monetary Stability?
Ans: It means maintaining stability in the value of money, avoiding inflation or deflation.

Q19. Name any two objectives of monetary policy in India.
Ans: (i) Economic growth, (ii) Price stability.

Q20. What is Credit Rationing?
Ans: It is a qualitative credit control measure where RBI restricts credit for unproductive purposes.

Part C – Ten Mark Questions (10 Qs)

(Long descriptive answers, exam-style, 250–300 words)

Q21. Explain the functions of the Central Bank.
Ans:

1. Issue of currency – monopoly of note issue.
2. Control of credit – through quantitative and qualitative measures.
3. Lender of last resort – provides emergency finance to banks.
4. Maintaining monetary stability.
5. Developmental functions – promoting rural credit, industries, financial inclusion.
   Thus, the Central Bank plays a key role in monetary and financial stability of the country.

Q22. Discuss the functions of Commercial Banks.
Ans:

- Primary functions: (i) Accepting deposits, (ii) Granting loans & advances.
- Secondary functions: (i) Agency functions (collection of cheques, paying bills), (ii) General utility services (locker, forex, ATM).
- Developmental role: credit to priority sectors, support to industries and agriculture.
  Hence, commercial banks are the backbone of economic growth.

Q23. Explain the process of Credit Creation by Commercial Banks.
Ans:

- Banks accept deposits from the public.
- They keep a part as reserves (CRR/SLR).
- The rest is given as loans.
- The borrowers spend the loan, and money comes back as deposits in the same or other banks.
- Again a portion is kept as reserve, rest loaned out.
- This cycle continues, and multiple credit is created, much more than the initial deposits.

Q24. What are the objectives of Monetary Policy in India?
Ans:

1. Price stability.
2. Control of inflation.
3. Economic growth.
4. Employment generation.
5. Balance of payments stability.
6. Monetary stability.
   Thus, monetary policy aims at growth with stability.

Q25. Explain the instruments of Monetary Policy.
Ans:

- Quantitative Instruments: CRR, SLR, Repo rate, Reverse repo, Bank rate, Open market operations.
- Qualitative Instruments: Credit rationing, margin requirements, direct action, regulation of consumer credit.
  Both sets of instruments help RBI regulate money supply and credit in the economy.

Q26. Discuss the role of RBI in controlling credit.
Ans:

- RBI uses CRR and SLR to reduce or increase lending capacity of banks.
- Repo and reverse repo are adjusted to influence borrowing and lending.
- Open Market Operations are used to absorb or release liquidity.
- Qualitative tools ensure credit flows to productive sectors.
  Thus, RBI maintains monetary discipline.

Q27. Define Monetary Policy. Discuss its role in India.
Ans:

- Monetary policy is the policy of the Central Bank to control supply of money and credit.
- In India, RBI uses it to ensure growth with stability.

- Role: check inflation, promote savings & investment, stabilize currency, promote employment, and encourage exports.
  Thus, monetary policy is crucial for India's economic development.

Q28. What are the limitations of Monetary Policy in developing countries like India?
Ans:

1. Existence of black money.
2. Lack of banking habits in rural areas.
3. Poor financial infrastructure.
4. Inflation due to supply-side factors.
5. Time lag in results.
   Hence, monetary policy alone cannot achieve development, it must be supported by fiscal policy.

Q29. Explain the role of Commercial Banks in credit creation and development.
Ans:

- Through credit creation, banks multiply money supply.
- This increases investment, production, trade, and income.
- They provide loans for agriculture, industries, transport, and housing.
- Promote entrepreneurship and economic growth.
  Therefore, commercial banks are major drivers of development.

Q30. Distinguish between Central Bank and Commercial Banks.
Ans:

- Central Bank: Apex institution, not profit-making, issues currency, regulates banking, controls credit, lender of last resort.
- Commercial Banks: Profit-making, accept deposits, provide loans, engage in day-to-day banking.
- Central Bank controls; commercial banks operate under its supervision.

TWO MARK:

1. What is a central bank?
A central bank is the apex financial institution of a country that controls money supply and credit, manages currency, and regulates commercial banks.

2. Give two examples of central banks.
Examples: Reserve Bank of India (RBI), Federal Reserve (USA).

3. Mention two functions of a central bank.
(1) Issuing currency notes, (2) Controlling credit in the economy.

4. What is the main objective of a central bank?
The main objective is to maintain price stability and promote economic growth.

5. What is the monopoly function of the central bank?
The central bank has the sole authority to issue currency notes in the country.

6. Define commercial banks.
Commercial banks are financial institutions that accept deposits from the public and provide loans for trade, business, and consumption.

7. State two primary functions of commercial banks.
(1) Accepting deposits, (2) Granting loans and advances.

8. What is credit creation?
Credit creation is the process by which commercial banks create money through multiple lending on the basis of primary deposits.

9. Name two types of deposits accepted by commercial banks.
(1) Demand deposits, (2) Time deposits.

10. What is the role of commercial banks in economic development?
They provide credit, mobilize savings, and promote trade, industry, and agriculture.

11. What do you mean by credit control?
Credit control means regulating the volume and direction of credit in the economy by the central bank.

12. Mention two quantitative methods of credit control.
(1) Bank Rate Policy, (2) Open Market Operations.

13. Mention two qualitative methods of credit control.
(1) Credit rationing, (2) Margin requirements.

14. What is the bank rate?
Bank rate is the minimum rate at which the central bank lends money to commercial banks.

15. Define open market operations.
Open market operations are the buying and selling of government securities by the central bank to control money supply.

16. What is cash reserve ratio (CRR)?
CRR is the percentage of deposits commercial banks must keep as cash with the central bank.

17. What is statutory liquidity ratio (SLR)?
SLR is the percentage of deposits commercial banks must maintain in the form of liquid assets before giving credit.

18. Define monetary policy.
Monetary policy is the central bank's policy of regulating money supply and credit to achieve economic objectives.

19. Mention two objectives of monetary policy.
(1) Price stability, (2) Economic growth.

20. What is the difference between expansionary and contractionary monetary policy?
Expansionary increases money supply; contractionary reduces money supply.

21. What is inflation control?
It is a major goal of monetary policy where money supply is reduced to control rising prices.

22. Mention two instruments of monetary policy.
(1) Quantitative instruments, (2) Qualitative instruments.

23. What is selective credit control?
It is a qualitative measure that regulates the flow of credit to specific sectors of the economy.

24. What is the main role of the RBI in India?
The RBI regulates currency, credit, and banking to ensure financial stability in India.

25. What is repo rate?
Repo rate is the rate at which the central bank lends money to commercial banks for short-term needs.

26. What is reverse repo rate?
It is the rate at which the central bank borrows money from commercial banks to absorb liquidity.

27. State the relationship between monetary policy and price stability.
Monetary policy controls money supply, which helps maintain stable prices.

28. Define liquidity preference.
Liquidity preference means the demand for holding cash instead of investing in assets.

29. Mention two roles of commercial banks in rural development.
(1) Providing loans to farmers, (2) Supporting rural small industries.

30. What is the ultimate aim of monetary policy?
The ultimate aim is to achieve sustainable economic growth with stability.

BOARD ANSWER:

Q1. Explain the functions of the Central Bank with a neat diagram.

Answer:

The Central Bank is the apex institution of a country's monetary and financial system. It regulates the supply of money, maintains stability, and controls credit in the economy. In India, the **Reserve Bank of India (RBI)** acts as the central bank.

1. Issuer of Currency

The Central Bank has the sole authority to issue currency notes. In India, except for one-rupee notes and coins, all currency is issued by the RBI. This ensures uniformity and prevents counterfeiting.

2. Controller of Credit

By using tools like repo rate, CRR, SLR, and open market operations, the Central Bank controls the flow of credit in the economy to maintain stability.

3. Lender of Last Resort

When commercial banks face financial crisis or liquidity shortage, the Central Bank provides emergency loans.

4. Custodian of Foreign Exchange

It manages foreign currency reserves, stabilizes exchange rates, and promotes international trade.

5. Regulator of Banks

The Central Bank supervises and regulates commercial banks to ensure proper functioning, solvency, and financial discipline.

Q2. Explain the role and functions of Commercial Banks.

Answer:

Commercial Banks are financial institutions that accept deposits from the public and provide loans for different purposes. They are the backbone of the economy because they mobilize savings and promote investment.

1. Primary Functions

(a) **Accepting Deposits** – Banks provide savings, current, and fixed deposit accounts.
(b) **Lending Loans** – Banks provide short-term and long-term loans to individuals, firms, and businesses.

2. Secondary Functions

(a) **Agency Functions** – Collection of cheques, transfer of money, payment of bills, etc.
(b) **Utility Functions** – Locker facility, credit cards, ATM, mobile banking, etc.

3. Role in Economy

- Mobilizes savings from households.
- Provides loans to entrepreneurs for business development.
- Helps in trade and commerce by issuing letters of credit, bank drafts, etc.
- Assists in implementing government policies by maintaining accounts of government.

4. Credit Creation

Commercial Banks multiply credit in the economy by keeping a part of deposits as reserve and lending the rest.

Q3. Explain the process of Credit Creation by Commercial Banks with diagram.

Answer:

One of the most important functions of commercial banks is **credit creation**. They do not create money directly but multiply deposits through lending.

Process of Credit Creation

- When a person deposits money in a bank, the bank keeps a part as **Cash Reserve Ratio (CRR)** and lends the remaining.
- The borrower spends this money, and the receiver deposits it in another bank.
- Again, a part is kept as reserve, and the rest is lent out.
- This process continues, and the total money supply in the economy becomes a multiple of the original deposit.

Formula of Credit Creation

$$Credit\ Multiplier = \frac{1}{CRR}$$

Example:

If CRR = 10%, then multiplier = 10.

So, ₹1,000 deposit creates ₹10,000 credit.

Q4. Discuss the objectives of Monetary Policy.

Answer:

Monetary policy refers to the policy of the Central Bank to regulate money supply and interest rates to achieve economic stability and growth.

Main Objectives

1. **Price Stability**
   To control inflation and prevent deflation by regulating money supply.

2. **Economic Growth**
   Monetary policy ensures adequate flow of credit for industries, agriculture, and infrastructure.

3. **Control of Inflation and Deflation**
   By adjusting repo rate, CRR, and open market operations, the Central Bank manages inflationary or deflationary trends.

4. **Employment Generation**
   By encouraging investment, monetary policy increases job opportunities.

5. **Balance of Payments Stability**
   Helps in maintaining a stable foreign exchange rate by regulating forex reserves.

6. **Financial Stability**
   Prevents banking crises by regulating credit flow and ensuring stability.

UNIT – 3

ONE MARK:

- **Q:** What does AD stand for in macroeconomics?
A: AD stands for Aggregate Demand.

- **Q:** What does AS stand for in macroeconomics?
A: AS stands for Aggregate Supply.

- **Q:** Who gave the Classical Theory of Employment?
A: Classical economists like J.B. Say and Ricardo.

- **Q:** What is Say's Law of Market?
A: "Supply creates its own demand."

- **Q:** In the Keynesian model, what is the main determinant of income and employment?
A: Aggregate Demand (AD).

- **Q:** What is the shape of Aggregate Supply curve in the Keynesian short run?
A: Horizontal (up to full employment level).

- **Q:** What is the consumption function?
A: The relation between consumption and income.

- **Q:** What is the saving function?
A: The relation between saving and income.

- **Q:** What is the investment function?
A: The relation between investment and interest rate/expectations.

- **Q:** What is equilibrium output?
A: Where Aggregate Demand equals Aggregate Supply.

- **Q:** Who gave the Keynesian theory of income and employment?
A: John Maynard Keynes.

- **Q:** What is the main assumption of Say's Law?
A: Full employment always exists in the economy.

- **Q:** What is effective demand according to Keynes?
A: The level of demand where AD equals AS and employment is determined.

- **Q:** What is the multiplier?
A: The ratio of change in income to change in investment.

 Q: Who introduced the concept of multiplier?
A: J.M. Keynes.

 Q: What is Aggregate Demand composed of?
A: Consumption + Investment (C + I).

 Q: What happens if AD < AS?
A: Unemployment increases.

 Q: What happens if AD > AS?
A: Inflation occurs.

 Q: What is the slope of the consumption function?
A: Marginal Propensity to Consume (MPC).

 Q: What is MPC?
A: Fraction of additional income spent on consumption.

 Q: What is MPS?
A: Fraction of additional income saved.

 Q: What is the relationship between MPC and MPS?
A: MPC + MPS = 1.

 Q: What does the saving curve start from?
A: Negative point (since some income is consumed even at zero income).

 Q: What is the slope of the investment function?
A: It depends on the interest rate.

 Q: In Keynes' model, what determines employment?
A: Effective Demand.

 Q: What is the formula for multiplier?
A: K = 1 / (1 – MPC).

 Q: In the classical model, what ensures full employment?
A: Flexible wages and prices.

 Q: What does aggregate supply represent?
A: Total output produced at different levels of employment.

 Q: What is autonomous investment?
A: Investment independent of income.

 Q: What is the key difference between classical and Keynesian theory?
A: Classical theory assumes full employment; Keynes assumes underemployment equilibrium.

TWO MARK:

1. What is Aggregate Demand (AD)?
Aggregate demand refers to the total demand for goods and services in an economy at a given level of income and employment. It includes consumption, investment, government expenditure, and net exports.

2. What is Aggregate Supply (AS)?
Aggregate supply represents the total quantity of goods and services that producers are willing to supply at a particular level of income and employment in the economy.

3. What is the Consumption Function?
The consumption function shows the relationship between consumption and income, indicating how much households consume at different levels of income.

4. What is the Saving Function?
The saving function represents the relationship between income and savings. It shows how much of the income is saved after meeting consumption expenditure.

5. Define Investment in economics.
Investment refers to the addition made to the capital stock of the economy in the form of new machines, buildings, or inventories to generate future income.

6. What is the Simple Keynesian Model?
The Simple Keynesian Model explains the determination of national income through aggregate demand and aggregate supply in the short run, assuming constant prices.

7. What is the Equilibrium Output?
Equilibrium output is the level of national income where aggregate demand equals aggregate supply, meaning planned savings equal planned investment.

8. What is the Multiplier?
The multiplier is the ratio of change in national income to the initial change in investment. It shows how investment leads to multiple increases in income.

9. State the formula of Multiplier.
The formula of the multiplier is: **K = 1 / (1 – MPC)**, where MPC is the marginal propensity to consume.

10. What is Marginal Propensity to Consume (MPC)?
MPC is the proportion of additional income that is spent on consumption. It lies between 0 and 1.

11. What is Marginal Propensity to Save (MPS)?
MPS is the proportion of additional income that is saved. It is equal to 1 – MPC.

12. Explain Say's Law of Market.
Say's Law states that "supply creates its own demand," meaning production automatically generates enough demand to purchase all the output.

13. What is the Classical Theory of Employment?
The classical theory assumes full employment and says that wages and prices adjust automatically to ensure equilibrium in the labor market.

14. How does Keynes criticize Say's Law?
Keynes argued that supply does not create its own demand, as unemployment and demand deficiency may exist in the economy.

15. What is effective demand according to Keynes?
Effective demand is the level of aggregate demand at which employment is determined, balancing total demand and total supply.

16. Differentiate between Ex-ante Saving and Ex-post Saving.
Ex-ante saving is planned saving by households, while ex-post saving refers to actual saving realized after expenditure.

17. Differentiate between Ex-ante Investment and Ex-post Investment.
Ex-ante investment is planned or intended investment, while ex-post investment is the actual level of investment carried out.

18. What is Involuntary Unemployment?
Involuntary unemployment occurs when people are willing to work at the prevailing wage rate but still cannot find jobs due to lack of demand.

19. What is the relationship between Consumption and Income?
Consumption increases with income, but not by the full amount of income. A part of income is always saved, which gives the saving function.

20. What is Autonomous Consumption?
Autonomous consumption is the minimum consumption that takes place even when income is zero.

21. What is Induced Consumption?
Induced consumption refers to consumption that changes with the change in the level of income.

22. What is the Paradox of Thrift?
The paradox of thrift refers to the situation where an increase in saving by

individuals reduces overall demand and income, thereby reducing total saving in the economy.

23. What is the Break-even Point in consumption?
The break-even point is the level of income where consumption equals income, and savings are zero.

24. What is the Investment Multiplier?
The investment multiplier explains how an initial increase in investment leads to multiple increases in income and employment in the economy.

25. What is Full Employment in Classical Economics?
Full employment means a situation where all those willing and able to work at the prevailing wage rate are employed, except for frictional unemployment.

BOARD ANSWER:

Q1. Explain the Keynesian theory of determination of income and employment with diagram.

Answer:

The Keynesian theory of income and employment is also called the **Effective Demand Theory**. It was given by **J.M. Keynes in his book "General Theory" (1936)** as a reaction to the Great Depression. Keynes opposed the classical view and emphasized the role of **aggregate demand** in determining income and employment.

Concept:

According to Keynes, employment depends on **effective demand**, which is determined by the **aggregate demand function (ADF)** and **aggregate supply function (ASF)**.

- **Aggregate Demand Function (ADF):** shows expected expenditure on goods and services at different levels of employment.
- **Aggregate Supply Function (ASF):** shows minimum proceeds that entrepreneurs expect to receive to employ a certain number of workers.

The equilibrium level of income and employment is reached when **ADF = ASF**.

Diagram:

```perl
Price/Income
    |
    |         ASF
    |        /
    |       /
    |      /
    |     /   AD
    |----/---------------- Employment
```

At point **E**, AD = AS, and this gives the equilibrium level of income and employment.

Explanation:

1. **Below Equilibrium (AD > AS):** When AD is greater, firms increase output and employment.
2. **Above Equilibrium (AD < AS):** Firms reduce output and employment.
3. **At Equilibrium (AD = AS):** Economy achieves stable income and employment.

Q2. What is the Consumption Function? Explain its importance in Keynesian economics with diagram.

Answer:

The **Consumption Function** is the functional relationship between **consumption (C)** and **income (Y)**. According to Keynes, as income increases, consumption also increases, but not by the full amount of income.

Equation:

$$C = a + bY$$

Where,

- **a = Autonomous consumption** (consumption at zero income)

- **b = Marginal Propensity to Consume (MPC)**
- **Y = Income**

Diagram:

```perl
C
|         /
|        /
|       /
|      /
|----/---------- Y
```

The straight line shows the consumption function. The gap at zero income is **autonomous consumption**.

Importance:

1. Explains why aggregate demand falls short of full employment output.
2. Basis for **Multiplier Theory**.
3. Shows role of government spending to increase demand.
4. Useful in explaining business cycles.

Q3. Explain the concept of Multiplier with diagram and its significance.

Answer:

The **Multiplier** refers to the multiple increase in income and employment due to an initial increase in investment. Introduced by Keynes, it shows how a small investment can lead to a larger increase in national income.

Formula:

$$K = \frac{1}{1 - MPC}$$

Where MPC = Marginal Propensity to Consume.

Process:

- Suppose government spends ₹100 crore on building roads.
- Workers get wages, spend on goods, and this expenditure becomes income for others.
- This cycle continues, multiplying the impact of initial investment.

Diagram:

perl

```perl
Income
|            /
|           /
|          /
|---------/---------
        Investment
```

Significance:

1. Explains role of public investment in recovery from depression.
2. Basis of government fiscal policy.
3. Helps in planning employment generation schemes.
4. Explains why small investments can revive an economy.

Q4. Discuss the Classical Theory of Employment and Say's Law of Market.

Answer:

The **Classical Theory of Employment** was given by economists like Adam Smith, Ricardo, and J.B. Say. According to them, markets are **self-adjusting**, and full employment is the natural condition of an economy.

Say's Law of Market:

"Supply creates its own demand."

- This means that every production automatically generates an equivalent demand because producers pay wages and rent, which are spent on buying goods.

Assumptions of Classical Theory:

1. Perfect competition.
2. Full employment is the norm.
3. Money is only a medium of exchange.
4. Wages and prices are flexible.

Criticism by Keynes:

1. Ignored involuntary unemployment.
2. Assumes perfect competition, which is unrealistic.
3. Ignores role of demand in determining employment.

Conclusion:

The classical theory believed in **self-adjusting markets**, but Keynes showed that without government intervention, economies can remain stuck in unemployment equilibrium.

Q5. Explain the determination of equilibrium output in the Keynesian model with diagram.

Answer:

The Keynesian model determines equilibrium output at the point where **Aggregate Demand (AD) = Aggregate Supply (AS)**.

Equation:

$Y=C+I$

Where,

- Y = National income
- C = Consumption
- I = Investment

Process:

1. At lower levels of income, AD > AS → output increases.
2. At higher levels, AD < AS → output decreases.
3. At equilibrium, AD = AS → stable income and employment.

Diagram:

Diagram:

```pgsql
AD
|        /
|       /
|------/-------
|     /
|---/---------- Y
AS
```

Explanation:

At point E, AD = AS, giving equilibrium income (Y*). This is not necessarily full employment. Keynes called it **underemployment equilibrium**.

Conclusion:

Thus, the Keynesian model shows that equilibrium can be reached even before full employment, hence the need for government intervention.

Q6. What are the differences between Classical and Keynesian theories of employment?

Answer:

Classical Theory:

1. Full employment is natural.
2. Supply creates its own demand (Say's Law).
3. Wages and prices are flexible.
4. No need for government intervention.

Keynesian Theory:

1. Employment depends on aggregate demand.
2. Unemployment can exist in equilibrium.
3. Wages are sticky downward.
4. Active government policy needed.

UNIT – 4

ONE MARK:

 Q. What is inflation?
Ans: Inflation is the sustained rise in the general price level of goods and services in an economy over time.

 Q. What does cost-push inflation mean?
Ans: Cost-push inflation occurs when production costs increase, leading to higher prices.

 Q. What is demand-pull inflation?
Ans: Demand-pull inflation occurs when aggregate demand exceeds aggregate supply, pushing prices upward.

 Q. Give one effect of inflation on fixed-income earners.
Ans: Inflation reduces their purchasing power.

 Q. Who benefits during inflation—borrowers or lenders?
Ans: Borrowers benefit because they repay loans with money of lower value.

 Q. What is creeping inflation?
Ans: Creeping inflation is a slow and mild rise in prices, usually below 3% annually.

 Q. What is galloping inflation?
Ans: Galloping inflation refers to a very high rate of inflation, often in double or triple digits.

 Q. What is hyperinflation?
Ans: Hyperinflation is an extremely rapid and uncontrollable rise in prices.

 Q. Name one monetary measure to control inflation.
Ans: Increasing the repo rate.

 Q. Name one fiscal measure to control inflation.
Ans: Reducing government expenditure.

 Q. What is deflation?
Ans: Deflation is a persistent fall in the general price level of goods and services.

 Q. What is unemployment?
Ans: Unemployment is a condition where people willing and able to work do not get jobs.

 Q. Name one type of unemployment.
Ans: Structural unemployment.

 Q. What is disguised unemployment?
Ans: When more people are employed than actually required, it is called disguised unemployment.

 Q. What is seasonal unemployment?
Ans: Seasonal unemployment occurs when people are unemployed during off-seasons in agriculture or industries.

 Q. What is frictional unemployment?
Ans: Frictional unemployment arises when workers are temporarily unemployed while switching jobs.

 Q. What is cyclical unemployment?
Ans: Cyclical unemployment occurs due to economic recessions or downturns.

 Q. What is voluntary unemployment?
Ans: Voluntary unemployment occurs when people choose not to work at the prevailing wage rate.

 Q. What is involuntary unemployment?
Ans: Involuntary unemployment occurs when people are willing to work but cannot find jobs.

 Q. What does the Phillips Curve show?
Ans: It shows the inverse relationship between inflation and unemployment.

 Q. What is stagflation?
Ans: Stagflation is a situation of high inflation and high unemployment occurring together.

 Q. What is the natural rate of unemployment?
Ans: It is the minimum level of unemployment that an economy cannot eliminate even in full employment.

 Q. Who gave the Phillips Curve?
Ans: A.W. Phillips.

 Q. What does the short-run Phillips Curve suggest?
Ans: It suggests an inverse relationship between inflation and unemployment in the short run.

 Q. What does the long-run Phillips Curve suggest?
Ans: In the long run, there is no trade-off between inflation and unemployment; it becomes vertical.

 Q. Give one harmful effect of inflation.
Ans: It reduces the real value of money.

 Q. Give one benefit of mild inflation.
Ans: Mild inflation encourages investment and production.

 Q. What is open unemployment?
Ans: Open unemployment means people are willing to work but cannot find any job at all.

 Q. Give one non-monetary measure to control inflation.
Ans: Increasing production of essential goods.

 Q. What is wage-price spiral?
Ans: It is a situation where rising wages increase costs and prices, which again leads to demand for higher wages.

TWO MARK:

1. What is inflation?

Inflation is a sustained rise in the general price level of goods and services in an economy over a period of time, leading to a decrease in the purchasing power of money.

---

2. What is demand-pull inflation?

Demand-pull inflation occurs when aggregate demand in the economy exceeds aggregate supply, causing prices to rise due to excess demand for goods and services.

---

3. What is cost-push inflation?

Cost-push inflation arises when production costs increase, such as wages or raw material prices, which forces producers to raise prices, leading to overall inflation.

---

4. State two main causes of inflation.

Two main causes of inflation are excess demand (demand-pull) and rising production costs (cost-push), both of which push prices upward.

---

5. What is core inflation?

Core inflation refers to inflation after excluding volatile items such as food and fuel, giving a clearer measure of long-term price trends.

---

6. Define headline inflation.

Headline inflation is the total inflation rate including all items such as food, fuel, and energy, showing the overall rise in price levels.

---

7. What is stagflation?

Stagflation is a situation where an economy faces high inflation along with high unemployment and stagnant economic growth.

---

8. What is deflation?

Deflation is the opposite of inflation, where the general price level of goods and services falls continuously over time.

---

9. What is disinflation?

Disinflation refers to a slowdown in the rate of inflation, meaning prices are still rising but at a slower pace than before.

---

10. What is hyperinflation?

Hyperinflation is an extreme form of inflation where prices rise uncontrollably at a very fast rate, often leading to the collapse of the currency system.

---

11. What are the effects of inflation on consumers?

Inflation reduces the purchasing power of money, making consumers spend more for the same goods, which lowers their real income and standard of living.

---

12. What are the effects of inflation on producers?

Inflation often benefits producers because they can sell goods at higher prices, which may increase profits, especially if production costs remain stable.

---

13. What is unemployment?

Unemployment is a condition where people who are willing and able to work at the prevailing wage rate do not get suitable jobs.

---

14. How is unemployment measured?

Unemployment is measured by dividing the number of unemployed persons by the total labor force and multiplying by 100 to get the unemployment rate.

---

15. What is disguised unemployment?

Disguised unemployment occurs when more people are employed than actually required, and even if some are removed, total production remains unchanged.

16. What is structural unemployment?

Structural unemployment happens when workers lack the skills needed for available jobs, often due to changes in technology or industry structure.

17. What is cyclical unemployment?

Cyclical unemployment arises due to fluctuations in the business cycle, especially during economic recessions when demand for goods and services falls.

18. What is frictional unemployment?

Frictional unemployment occurs when people are temporarily unemployed while shifting from one job to another or entering the workforce.

19. What is seasonal unemployment?

Seasonal unemployment happens when jobs are only available in certain seasons, like agriculture, tourism, or construction sectors.

20. What is voluntary unemployment?

Voluntary unemployment occurs when individuals choose not to work at the prevailing wage rate, even though jobs are available.

21. State two consequences of unemployment.

Unemployment reduces income levels, leading to poverty and low demand in the economy, while also causing social problems like crime and frustration.

22. What is the Phillips Curve?

The Phillips Curve shows the inverse relationship between inflation and unemployment, suggesting that as inflation rises, unemployment falls in the short run.

---

23. What does the long-run Phillips Curve show?

The long-run Phillips Curve is vertical, indicating that in the long run, there is no trade-off between inflation and unemployment.

---

24. How can inflation be controlled?

Inflation can be controlled through monetary measures like increasing interest rates, or fiscal measures such as reducing government spending and increasing taxes.

---

25. How is stagflation different from normal inflation?

Unlike normal inflation, stagflation includes rising prices with stagnant economic growth and high unemployment, making it a more serious economic problem.

Q1. Explain the meaning, causes, and effects of Demand-Pull and Cost-Push Inflation with a diagram.

Answer:

Inflation refers to the persistent rise in the general price level of goods and services over a period of time. It reduces the purchasing power of money and affects the overall economy. Two major causes of inflation are **demand-pull inflation** and **cost-push inflation**.

Demand-Pull Inflation:
This type of inflation arises when aggregate demand in an economy exceeds aggregate supply. It usually occurs in times of economic growth when people have higher incomes and increased spending power. When demand for goods and services rises sharply but supply does not increase proportionately, prices

rise. For example, if government spending increases without a corresponding rise in production, demand-pull inflation occurs.

Diagram:

```
       Price Level
           |
           |       AD2
           |      /
           |     /
           |    /
           |   /   AD1
           |  /
           | /
           |/________________ Output
                AS
```

Here, as aggregate demand shifts from **AD1 to AD2**, price level rises.

Cost-Push Inflation:
Cost-push inflation happens due to an increase in the cost of production. Higher wages, increase in prices of raw materials, or rise in fuel prices lead to higher production costs, and firms shift this burden to consumers by raising prices. Unlike demand-pull, cost-push inflation occurs even when demand is not rising.

Effects of Inflation:

1. **On Consumers:** Reduced purchasing power, decline in savings.
2. **On Producers:** Higher profits in the short run due to price rise.
3. **On Economy:** Income inequality increases, balance of payments worsens.

Thus, both demand-pull and cost-push inflation harm the economy if not controlled by proper monetary and fiscal measures.

Q2. Discuss the effects of inflation on different sections of society and the economy.

Answer:

Inflation affects people and the economy differently depending on their income, occupation, and wealth. Its effects can be both positive and negative.

Effects on Consumers:
Inflation reduces the purchasing power of money. People with fixed incomes such as pensioners, salaried employees, and daily wage workers suffer the most because their income does not increase with prices.

Effects on Producers:
In the short run, producers benefit from inflation. They get higher prices for their goods and make larger profits. However, in the long run, rising input costs reduce profit margins and discourage production.

Effects on Debtors and Creditors:
Debtors gain during inflation because they repay loans with money that has less purchasing power. Creditors, on the other hand, lose because the money they receive is worth less.

Effects on Economy:

1. **On Savings:** People lose the incentive to save because the value of money falls.
2. **On Investment:** Inflation may encourage speculative investments rather than productive ones.
3. **On Distribution:** Income inequality increases because the rich gain from rising asset prices while the poor suffer from rising costs of living.
4. **On Balance of Payments:** Domestic goods become expensive compared to foreign goods, leading to more imports and fewer exports.

Conclusion:
Inflation benefits some but harms the majority. Hence, controlling inflation is essential to maintain economic stability and social justice.

Q3. What are the measures to control inflation? Explain with suitable diagrams.

Answer:

Inflation control is essential for maintaining stability in an economy. The government uses both **monetary policy** and **fiscal policy** to control inflation.

Monetary Measures:

1. **Control of Credit:** Central bank raises interest rates (Repo rate) to reduce borrowing.
2. **Open Market Operations:** Sale of government securities reduces liquidity.
3. **Increase in CRR and SLR:** Banks are required to keep more money with the RBI, reducing lending capacity.

Fiscal Measures:

1. **Reduction in Public Expenditure:** Government reduces its own spending to lower demand.
2. **Increase in Taxes:** Higher taxes reduce disposable income of people.
3. **Public Borrowing:** Government borrows from the public, reducing money circulation.

Direct Measures:
Price control and rationing can also help to control inflation in essential commodities.

Diagram:

```
Price Level
    |
    |       AD1
    |      /
    |     /
    |    /
    |   /
    |  / AD2
    | /
    |/________________ Output
          AS
```

When demand is reduced through policies, AD shifts back from **AD2 to AD1**, lowering inflation.

Conclusion:
A mix of monetary and fiscal measures is necessary for effective control of inflation.

Q4. Explain the concept of unemployment, its measurement, and types.

Answer:

Unemployment is a situation where individuals who are willing and able to work cannot find employment. It is a major problem in developing economies like India.

Measurement of Unemployment:

1. **Usual Status Approach:** Measures unemployment over a long period, e.g., a year.
2. **Current Weekly Status (CWS):** Measures unemployment based on a week.
3. **Current Daily Status (CDS):** Measures unemployment for each day.

Types of Unemployment:

1. **Frictional Unemployment:** Caused due to movement of people between jobs.
2. **Structural Unemployment:** Due to mismatch of skills and job opportunities.
3. **Cyclical Unemployment:** Occurs due to fall in demand during economic recession.
4. **Seasonal Unemployment:** Found in agriculture and seasonal industries.
5. **Disguised Unemployment:** More people employed than required, common in rural areas.

Diagram: (Labour Market)

```
Wage Rate
    |
    |------ Ls
    |
    |
    |
    |
    |
    |__________________ Labour
                Ld
```

If labour supply (Ls) exceeds labour demand (Ld), unemployment arises.

Conclusion:
Unemployment wastes human resources and hampers economic growth. Proper training, job creation, and industrialisation are necessary to reduce unemployment.

Q5. Explain the Phillips Curve and its relevance in the short run and long run.

Answer:

The **Phillips Curve** shows the inverse relationship between inflation and unemployment.

Short-Run Phillips Curve (SRPC):
In the short run, there is a trade-off between inflation and unemployment. If the government reduces unemployment by increasing demand, inflation rises. Conversely, controlling inflation increases unemployment.

Diagram (Short Run):

```
Inflation (%)
    |
    |\
    | \
    |  \
    |   \
    |    \
    |     \
    |______\_______ Unemployment (%)
```

SRPC slopes downward, showing inverse relation.

Long-Run Phillips Curve (LRPC):
In the long run, this trade-off disappears. According to Milton Friedman, unemployment tends to return to its **natural rate** regardless of inflation. The long-run curve is vertical.

Diagram (Long Run):

```
      Inflation (%)
          |
          |       |
          |       |
          |       |
          |       |
          |       |
          |_______|_______ Unemployment (%)
                UN
```

Relevance:
In the short run, policymakers may use this trade-off to balance unemployment and inflation. But in the long run, inflation cannot reduce unemployment permanently.

Conclusion:
Phillips Curve highlights the complexity of inflation-unemployment relationship, guiding policymakers in framing economic strategies.

Q6. What is Stagflation? Explain its causes and consequences.

Answer:

Stagflation is a situation where inflation and unemployment rise simultaneously, along with stagnant growth. It contradicts the Phillips Curve, which suggested an inverse relationship between inflation and unemployment.

Causes of Stagflation:

1. **Supply Shocks:** Sudden rise in oil or raw material prices increases costs, leading to inflation and unemployment.
2. **Structural Problems:** Low productivity and inefficiency reduce output.
3. **Faulty Policies:** Excessive monetary expansion with supply-side bottlenecks worsens the problem.

Consequences of Stagflation:

1. High prices reduce purchasing power.
2. Rising unemployment creates social unrest.

3. Economic growth slows down.
4. Poor sections of society suffer more due to both high inflation and lack of jobs.

Diagram:

```
Price Level
    |
    |       AS2
    |      /
    |     /
    |    /
    |   /
    |  /
    | /    AS1
    |/
    |/________________ Output
       AD
```


Here, aggregate supply shifts left from **AS1 to AS2**, causing higher prices and lower output, i.e., stagflation.

Conclusion:
Stagflation is dangerous because traditional monetary and fiscal tools are less effective. Supply-side policies, technological improvements, and productivity growth are required to solve it.

UNIT – 5

ONE MARK:

1. **Q:** What is Balance of Payments (BOP)?
   A: BOP is a systematic record of all economic transactions between a country and the rest of the world during a specific period.
2. **Q:** What are the two main components of BOP?
   A: Current Account and Capital Account.
3. **Q:** What is included in the Current Account?
   A: Exports, imports of goods and services, income, and unilateral transfers.
4. **Q:** What is included in the Capital Account?
   A: Investments, loans, and banking capital.
5. **Q:** What is Balance of Trade (BOT)?
   A: BOT is the difference between the value of exports and imports of goods.
6. **Q:** What is a trade surplus?
   A: When exports are greater than imports.
7. **Q:** What is a trade deficit?
   A: When imports are greater than exports.
8. **Q:** Give one cause of disequilibrium in BOP.
   A: Excess imports over exports.
9. **Q:** What does BOP equilibrium mean?
   A: When inflows and outflows of foreign exchange are equal.
10. **Q:** What is foreign exchange?
    A: Foreign exchange refers to foreign currencies used for international trade.
11. **Q:** What is an exchange rate?
    A: It is the rate at which one currency is exchanged for another.
12. **Q:** What is a fixed exchange rate?
    A: A system where the currency value is officially fixed by the government.
13. **Q:** What is a flexible exchange rate?
    A: A system where exchange rate is determined by demand and supply forces in the market.
14. **Q:** What is managed floating exchange rate?
    A: A system where exchange rate is mainly market-driven but government intervenes occasionally.
15. **Q:** What is depreciation of currency?
    A: Fall in the value of domestic currency in terms of foreign currency under flexible system.

16. **Q:** What is devaluation of currency?
    A: Official lowering of the value of a country's currency under fixed system.
17. **Q:** What is appreciation of currency?
    A: Rise in the value of domestic currency against foreign currency.
18. **Q:** What is revaluation of currency?
    A: Official increase in the value of a country's currency.
19. **Q:** Name one corrective measure of BOP disequilibrium.
    A: Export promotion.
20. **Q:** What is autonomous capital flow?
    A: Capital flow independent of BOP position, motivated by profit.
21. **Q:** What is accommodating capital flow?
    A: Capital movement to correct disequilibrium in BOP.
22. **Q:** What is invisible trade?
    A: Trade in services such as banking, shipping, and insurance.
23. **Q:** What is monetary disequilibrium in BOP?
    A: Disequilibrium caused by inflation or deflation affecting trade balance.
24. **Q:** What is equilibrium exchange rate?
    A: The rate at which demand for foreign exchange equals its supply.
25. **Q:** What is dumping?
    A: Selling goods in foreign markets at very low prices.
26. **Q:** What is import substitution?
    A: Producing goods domestically instead of importing them.
27. **Q:** What is export promotion policy?
    A: Policies encouraging more exports to improve BOP.
28. **Q:** What is the role of IMF in BOP disequilibrium?
    A: IMF provides loans to countries facing BOP crises.
29. **Q:** What is currency convertibility?
    A: Freedom to exchange domestic currency for foreign currency without restrictions.
30. **Q:** What is balance of invisible items?
    A: Difference between receipts and payments of services and transfers.

TWO MARK:

Q1. What is Balance of Payments (BOP)?
Balance of Payments is a systematic record of all economic transactions between residents of a country and the rest of the world during a given period, usually one year.

Q2. What are the two main components of BOP?
The two main components are:

1. Current Account – includes trade in goods, services, income, and transfers.
2. Capital Account – includes capital inflows and outflows like loans, investments, and banking capital.

Q3. Define Balance of Trade (BOT).
Balance of Trade refers to the difference between the value of a country's exports and imports of goods during a specific period.

Q4. What is a favorable balance of trade?
A favorable balance of trade occurs when a country's exports of goods exceed its imports, resulting in a trade surplus.

Q5. What is an unfavorable balance of trade?
An unfavorable balance of trade happens when a country's imports exceed its exports, leading to a trade deficit.

Q6. State two causes of disequilibrium in BOP.
Disequilibrium in BOP may arise due to:

1. Excess imports over exports.
2. Large-scale foreign borrowing and debt repayments.

Q7. How can inflation cause BOP disequilibrium?
Inflation makes domestic goods expensive, reducing exports and increasing imports, which causes a BOP deficit.

Q8. What is meant by devaluation of currency?
Devaluation means an official reduction in the external value of a country's currency to make exports cheaper and imports costlier, thereby correcting BOP disequilibrium.

Q9. How does export promotion help in correcting BOP disequilibrium?
By encouraging exports through subsidies, incentives, and better trade policies, a country can earn more foreign exchange and reduce BOP deficit.

Q10. What is Foreign Exchange Rate?
Foreign exchange rate refers to the price of one country's currency in terms of another country's currency.

Q11. Mention two types of foreign exchange rate.
The two types are:

1. Fixed Exchange Rate – controlled by the government or central bank.
2. Flexible Exchange Rate – determined by demand and supply in the market.

Q12. What is a fixed exchange rate system?
It is a system where the value of currency is officially fixed by the government and is not allowed to fluctuate freely.

Q13. What is a flexible exchange rate system?
It is a system where the exchange rate is determined by the demand and supply forces of foreign exchange in the market.

Q14. What is meant by managed floating exchange rate?
It is a mixed system where the exchange rate is mainly determined by market forces, but the central bank intervenes to stabilize extreme fluctuations.

Q15. How is equilibrium exchange rate determined?
The equilibrium exchange rate is determined at the point where the demand for foreign exchange equals its supply in the market.

Q16. What is appreciation of currency?
Appreciation refers to an increase in the value of a country's currency in relation to another under a flexible exchange rate system.

Q17. What is depreciation of currency?
Depreciation refers to a fall in the value of a country's currency in relation to another under a flexible exchange rate system.

Q18. What is revaluation of currency?
Revaluation means an official increase in the external value of a country's currency by the government.

Q19. What is capital account in BOP?
The capital account records transactions of capital inflows and outflows, such as foreign investment, loans, and banking capital.

Q20. What is current account in BOP?
The current account records transactions of goods, services, incomes, and unilateral transfers between residents and the rest of the world.

Q21. How does foreign investment affect BOP?
Foreign investment brings capital inflow, improving the capital account and helping in correcting BOP deficits.

Q22. What is disequilibrium in Balance of Payments?
When a country's receipts from abroad fall short of its payments to other countries, it is called disequilibrium in BOP.

Q23. What is meant by exchange control?
Exchange control refers to government regulation of buying and selling of foreign currencies to stabilize BOP and control exchange rate.

Q24. How does import substitution correct BOP deficit?
Import substitution reduces dependence on foreign goods by promoting domestic production, thus saving foreign exchange and correcting BOP.

Q25. State the difference between BOP and BOT.
BOT considers only trade in goods, while BOP includes both goods and services, capital movements, and transfers.

BOARD ANSWER:

Q1. Explain the structure of Balance of Payments (BOP) with its components.

Introduction

The Balance of Payments (BOP) is a systematic record of all economic transactions between the residents of a country and the rest of the world during a specific period, usually one year. It reflects the nation's financial position globally and indicates its trade and capital flow health.

Components of BOP

1. **Current Account**
    - Includes trade in goods (exports and imports).
    - Trade in services (IT services, shipping, tourism).
    - Net income from abroad (interest, dividends).
    - Unilateral transfers (remittances, gifts, aid).
2. **Capital Account**
    - Records capital transfers (debt forgiveness, migrant transfers).
    - Acquisition and disposal of non-produced, non-financial assets.

3. **Financial Account**
    - Direct investment (FDI inflows/outflows).
    - Portfolio investment (shares, bonds).
    - Other investments (loans, banking capital).
    - Reserve assets (foreign exchange reserves managed by central banks).
4. **Errors and Omissions**
    - Balancing item to adjust statistical discrepancies.

Equilibrium in BOP

- BOP is always balanced in accounting terms, but may show **surplus** or **deficit** in specific accounts.
- **Surplus** → Indicates stronger foreign trade position.
- **Deficit** → Shows excessive imports or capital outflows.

Conclusion

The Balance of Payments serves as a mirror of a country's international economic relations, highlighting trade competitiveness, foreign investment inflows, and external debt position. Policymakers use BOP to frame monetary, fiscal, and trade policies.

Q2. What is Balance of Trade? Explain its importance in the economy.

Introduction

Balance of Trade (BOT) refers to the difference between the value of a country's exports of goods and its imports of goods during a given period. It is the most visible and important part of the Current Account.

Explanation

- **Favorable BOT:** Exports > Imports (surplus).
- **Unfavorable BOT:** Imports > Exports (deficit).
- BOT does not include invisible items like services or remittances.

Importance

1. **Indicator of Economic Strength** – Surplus BOT shows productive efficiency.
2. **Foreign Exchange Earnings** – More exports generate more reserves.
3. **Employment Generation** – Export-oriented industries create jobs.
4. **Inflation Control** – Importing essential goods keeps prices stable.

5. **Policy Framing** – Helps in designing trade and tariff policies.

Conclusion

Though Balance of Trade is a narrow concept compared to BOP, it directly reflects the strength of international trade and is crucial for economic development and stability.

Q3. Discuss the causes of Disequilibrium in Balance of Payments.

Introduction

BOP equilibrium is necessary for economic stability. When receipts from abroad are less than payments, a **disequilibrium** arises, creating economic imbalances.

Causes

1. **Trade Imbalance** – Excessive imports over exports.
2. **Developmental Programs** – High imports of capital goods for industrialization.
3. **Population Growth** – High demand for food, oil, and consumer goods imports.
4. **Inflation** – Makes exports costly and imports cheaper.
5. **Foreign Debt Repayment** – Large outflows burden the BOP.
6. **Structural Weakness** – Dependence on few commodities for export.
7. **Political Instability** – Reduces foreign investment inflows.

Q4. Explain the corrective measures for Balance of Payments disequilibrium.

Introduction

A disequilibrium in BOP creates financial stress. It can be corrected through monetary, fiscal, and trade measures.

Measures

1. **Export Promotion** – Subsidies, incentives, and better infrastructure.
2. **Import Substitution** – Domestic production of essential goods.
3. **Devaluation of Currency** – Makes exports cheaper, imports costlier.
4. **Foreign Exchange Control** – Regulating imports and capital outflows.
5. **Foreign Aid & Loans** – Short-term correction.
6. **Industrial Development** – Reducing dependency on foreign goods.
7. **Tourism & Remittances** – Encouraging invisible earnings.

Q5. Explain the determination of equilibrium foreign exchange rate with diagram.

Introduction

Foreign exchange rate refers to the price of one currency expressed in terms of another. It is determined by the **demand and supply of foreign currency** in the exchange market.

Determination

- **Demand for foreign currency** arises from imports, tourism, investment abroad.
- **Supply of foreign currency** arises from exports, remittances, foreign investment inflows.

Equilibrium

The point where demand and supply curves of foreign exchange intersect determines the equilibrium rate.

Diagram

```
          Price of $ (Exchange Rate)
                \
                 \   Demand for $
                  \
                   \_________
                   /        \
                  /          \ Supply of $
                 /            \
----------------------------------------------
                Quantity of Foreign Exchange
```

Explanation

- If exchange rate is **above equilibrium**, supply exceeds demand → currency depreciates.
- If rate is **below equilibrium**, demand exceeds supply → currency appreciates.

Conclusion

Equilibrium exchange rate ensures smooth functioning of international trade by balancing the demand and supply of foreign currency.

Q6. Discuss different types of foreign exchange rates with examples.

Introduction

Foreign exchange rate systems differ across nations depending on government intervention and market freedom.

Types

1. **Fixed Exchange Rate** – Rate decided by the government (e.g., Bretton Woods system).
2. **Flexible Exchange Rate** – Determined freely by demand and supply forces.
3. **Managed Floating** – Partial control by central bank along with market forces.
4. **Dual Exchange Rate** – Two rates for different purposes like trade and capital transactions.
5. **Purchasing Power Parity (PPP) Rate** – Based on relative prices of goods in two countries.