SES'S L.S.RAHEJA COLLEGE OF ARTS AND COMMERCE

Course: Business Economics II Unit: 2 , 4 Prepared by: Jyoti Parimal Sarkar

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Note: The answers are discussed in pointers. While answering these questions, the points need to be elaborated from the reading materials provided to you.

1) Discuss Keynesian liquidity preference theory. OR Explain the Total demand theory of money by Keynes.

Ans. Keynes in his liquidity preference theory of demand for money--

- Emphasised that demand for money is based on two important functions- medium of exchange and store value of money.
- Explained the demand for money for three main motives:

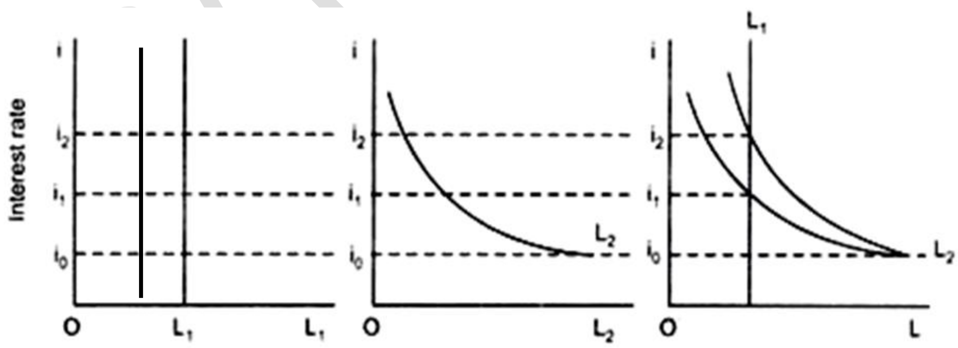
  1. Transaction motive
  2. Precautionary motive
  3. Speculative motive

- Total demand for money is divided into two –

  i. Active cash balance, $L_1 = L_1(Y)$. It includes demand for money for transaction motive and precautionary motive. As income,Y increases, both transaction and precautionary demand increases and hence demand for active cash balance increases. L_1 is interest inelastic.

  ii. Idle cash balance, $L_2 = L_2(r)$. It explains demand for money for speculative motive. People demand money for buying bonds. L_2 is inversely related to interest rate,r

- Total demand for money, $L = L_1(Y) + L_2(r) = L(Y,r)$
- Graph of Derivation of Total Demand



a) Demand for Active Cash b) Demand for Idle Cash c) Total Demand for Money

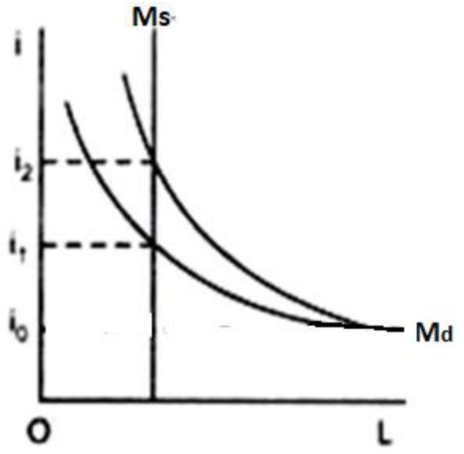
- Explanation of the diagram-
  - Demand for active cash does depend on income and not on interest rate. Thus, L_1 is vertical.
  - L_2 is inversely related to interest rate,r
  - L is also inversely related to interest rate,r
  - If L_1 and L_2 changes, L changes

- Here, L_1 has shifted to the left, L curve has also shifted to the left. As total demand for money has declined, interest rate has declined from r_2 to r_1

2) Explain Keynesian Liquidity Preference Theory of interest.

Ans. Interest is monetary phenomenon and is determined by the demand and supply of money.

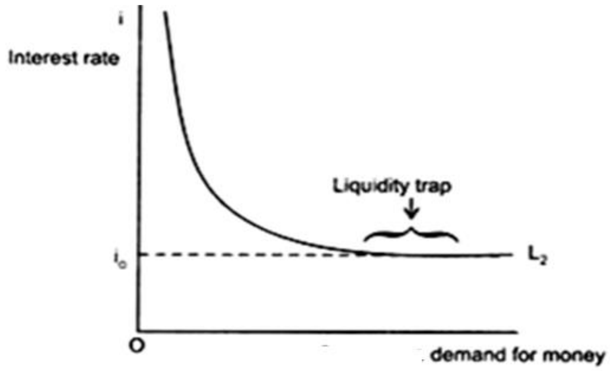
- It is a price for parting with liquidity.
- **Demand for money (M_d)**: People's desire to hold cash or their preference for liquidity based on the three main motives-transactions, precautionary and speculative.
- **Supply of money (M_s)**: Determined by the monetary authority and other factors other than interest rate.
- M_s is constant and is represented by a vertical line.
- Rate of interest is determined at the point where M_s intersects M_d
- A change in demand or supply or both will result in a change in interest rate.
- Daigram for Keynesian Liquidity Preference Theory of interest.
- Explanation- Interest rate is determined at the point where M_s and M_d intersect. M_s shifts to the left, interest rate declines.



3) Write short note on Liquidity trap

Ans. There exist inverse relationship between total demand for money and interest rate due to speculative demand.

- As interest is low, total demand for money declines for speculation.
- At low interest rate, demand for ideal cash increase.
- Liquidity trap is a situation where money is trap in the financial situation due to very low interest rate.
- During depression, interest rate is very low and sometimes approaches zero.
- Expalin the daigram



4) Explain the constituents of money supply.

Ans. Money supply refers to the stock of money i.e., the total of money in the economy at a particular point of time.

- Two approaches to the constituents
  1) Traditional Approach (Narrow Money)-
     - Money supply is defined as currency with public and demand deposits with commercial banks.
     - Constitutes of cash, coins and DDs with banks that can be quickly withdrawn by drawing cheque against it.- liquid form of money
     - Satisfies the medium of exchange function
     - Narrower definition.
  2) Modern Approach (Broad Money)-
     - Evolved from the earlier approach and includes all very close substitutes of money (currency money and near money)
     - It consists of coins, currency notes, demand deposits of commercial banks, time deposits of banks, financial assets, treasury bills, bills of exchange, etc.

5) Discuss the various factors affecting supply of money.

Ans. The various factors affecting or determinants of supply of money are-

1) High Powered Money/ Base Money
2) Money multiplier- Multiple Credit Creation by Banks
   i. Credit Deposit Ratio- Community's Choice
   ii. Reserve Deposit Ratio- CRR
3) Extend of Monetisation
4) Fiscal Policy
5) Monetary Policy
6) Velocity of Circulation

6) Write a short note on velocity of circulation of money

Ans. Average number of times a unit of money changes hands during a given year.

- Depends upon the how many people spend money and how frequently.
- Higher the velocity, greater the money supply.
- Ms= M X V

  here, Ms- money supply
  M-money in circulation
  V- velocity
- There are two types of velocity of circulation of money—Transaction velocity and Income velocity
- Transaction velocity- Ratio of annual volume of transaction to the stock of money.
- Income velocity- Average number of times a unit of money is used for making payments for final goods and services.

7) Various factors affecting velocity of circulation of money.

Ans. There are two types of velocity of circulation of money—Transaction velocity and Income velocity

- Factors affecting transaction velocity—
  i. Volume of production and trade
  ii. Institutional arrangements
  iii. Saving
  iv. Changes in price level
  v. Regularity and certainty of income receipts
- Factors affecting income velocity—
  i. Growth of NI
  ii. Demand for idle cash
  iii. Quantity of money supply

8) Explain Classical approach to quantity theory of money. Critically evaluate it.

Ans. Quantity theory of money explains the relationship between quantity of money and price level.

- Classical approach is Fisher's equation of exchange—MV=PT

  or, P= MV/T
- V and T remains constant and are influenced by factors outside the equation.
- P and M are directly related, other things remaining constant.
- Critical evaluation:

  1) Mere truism

2) Constancy of V and T
3) Conceptual inconsistency
4) M and P relationship
5) Emphasis on single cause of inflation
6) Variations in piece level
7) Not applicable in short term
8) One sided
9) Ignore store of value function of money
10) Neglects interest rate
11) Ignores the real balance effect
12) Full employment

9) Explain Cash balance approach to quantity theory of money. Critically evaluate it.

Ans. Quantity theory of money explains the relationship between quantity of money and price level.

- Cash-balance approach of Cambridge economist, Marshall and Pigou gave the Cambridge equation—Md= kPY
- At full employment, Ms=Md=M

  So, M=kPY

  or, P= M/kY

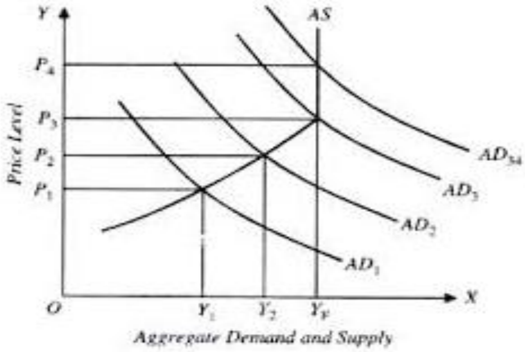
- Here, k is constant and given by transaction demand of money.
- Y is constant at full employment
- So, P depends directly on M (value of money)
- Critical evaluation:
  1) Ignores factors that change P.
  2) Does not take into account all the motives of holding money
  3) Considers only consumption goods
  4) Static theory
  5) Ignores the linkage between P and interest rate
  6) Cannot explain business cycle
  7) M depends on k and k itself depends om M
  8) Elasticity of demand for money

10) Write short note on demand Pull inflation and cost push inflation

Ans. Demand Pull Inflation- It is caused due to excess demand.

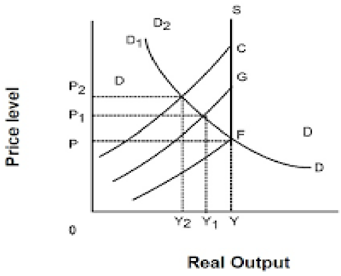
- The various reasons that could lead to excess demand are:

i. Population
ii. Increased Money Supply by Monetary Authority
iii. More Credit Creation by Commercial Banks
iv. Repayment of Public Debt
v. Existence of Black Money



Demand-Pull Inflation

Cost Pull inflation—inflation is caused due to increase in cost of production. The reasons for such increase are due to the following reason:



i.Wage-price Shock
ii.Material Cost- Farm Price Shock
iii.Increase in Profit Margin
iv.Natural Calamities
v.Oil Shocks
vi.Import Price Shock

11) Discuss the various effects of inflation.

Ans. <u>Effects On Production-</u>

- Misallocation of resources
- Changes in the system of transactions
- Reduction production
- Fall in the quality
- Hoarding and Black Marketing
- Reduction in Saving
- Hinders foreign capital
- Encourages Speculation

<u>Effects On different income groups-</u>

- Debtors and Creditors
- Salaried Persons
- Wage earners
- Fixed Income Group People
- Equity holders and Investors
- Businessmen-producers, traders and real estate holders

- Agriculturalists-landlords, peasant proprietors and landless
- Government

Effects on Redistribution of income and wealth-

- Change in real value of factor incomes
- Change of distribution of income overtime

Other Effects-

- Balance of Payments
- Exchange Rate
- Economic instability
- Political instability

12) Explain the various instruments of money policy or credit policy.

Ans. Monetary policy is concerned with the changes in the supply of money and credit.

- Undertaken by the central bank to influence the availability, cost and use of money and credit with the help of monetary techniques to achieve specific objectives.

- In India the main objectives of monetary policy are to achieve price stability, financial stability and adequate availability of credit for growth.

- Quantitative instruments—It directly effects the quantity of money supply or credit
  - Bank Rate
  - Reserve Requirement
  - OMO
  - Repos & Reverse Repos
- Qualitative instruments— It is indirect control over money supply or credit.
  - Margin Requirement
  - Consumer Credit Regulation
  - Rationing of Credit
  - Moral Suasion
  - Direct Action

13) Discuss the Ricardian theory of International tarde theory.

Ans. Trade between nations take place if the traders saw a comparative cost advantage in buying a particular good from a foreign country rather than producing and buying the same good domestically.

- Example: England has absolute advantage in production of both the commodity.

- Labour is measured in terms of labour days or labour hours (L).

Countries	1 unit of Bread (B)	1 unit of Cloth (C)
India	120 L	100 L
England	80 L	90 L

- We calculate the opportunity cost of producing both the commodity

Countries	1 unit of Bread (B)	1 unit of Cloth (C)
India	120/100 = 1.20 120 Labour gives 1 B or 1.20 C	100/120 = 0.83 100 Labour gives 1 C or 0.83 B
England	80/90 = 0.88 80 Labour gives 1 B or 0.88 C	90/ 80 = 1.12 90 Labour gives 1 C or 1.12 B

- Opportunity cost of producing bread is more in England and producing cloth is more in India.
- England will specialize in bread and export bread whereas India will specialize in cloth and export cloth
- Assumptions:

    i. 2 country-2 commodity model- 1factor of production, Labour
    ii. Taste and preference of both the countries are similar and constant
    iii. All labour are homogeneous- identical efficiency
    iv. Supply of labour unchanged
    v. Full employment
    vi. Production under constant returns to scale
    vii. No currency-barter system
    viii. Free trade
    ix. No transportation cost
    x. Perfect mobility of factors of production within the country
    xi. Perfect competition

14) Discuss the Modern theory of international trade.

Ans. The Modern theory of international theory is also known as Hecsher-Ohlin (H-O) theory or Factor Endowment theory.

- According to Hecksher and Ohlin, trade occurs between different countries because different countries have different factor endowments.
- H-O theory states that countries which is abundant in labour will export labour intensive goods and countries which are rich/ abundant in capital will export capital intensive goods

- $(Pk/PL)_{England} < (Pk/PL)_{India}$
- Assumption:

  i. Two countries involved
  ii. Two factors of production- Labour and capital
  iii. Two commodities produced
  iv. Perfect competition in both commodity and factor markets
  v. production function homogeneous
  vi. Supply of labour unchanged
  vii. Full employment
  viii. Free trade
  ix. No transportation cost
  x. Perfect mobility of factors of production within the country

15) Explain the structure of Balance of Payment.

Ans. Systematic record of economic transactions between a country to the rest of the world for a given period of time.

- It consist of 2 different types of accounts—current account and capital account.
- Current Account is the record of all transactions which give rise to or use up of national income.
- Capital Account consists of short-term and long term capital transactions.
- It takes credit on the left hand side and debit on the right hand side of the account. All transactions are recorded under the debit and credit heads and are automatically kept in balance.

Receipts(credit)	**Payments (debits)**
Current Account	
1. Export of goods	2. Import of goods
2. Exports of services 3. Interest, profits, dividends received 4. Unilateral Payments	5. Imports of services 6. Interest, profits, dividends paid 7. Unilateral payments
Capital Account	
1. Foreign investments 2. Short-term borrowing 3. Medium and long term borrowing	4. Foreign investments abroad 5. Short-term lending 6. Medium and long term lending
Errors and Omissions	
Overall Balance = Current Account + Capital Accounts Balance	
Change in reserves (+)	Change in reserves (-)
Total receipts	Total Payments

16) Discuss the various causes of disequilibrium in Balance of Payments.

Ans. The various causes are:

- Trade Cycles
- Industrialization and development Programmes
- Changes in Export Demand
- Demonstration Effect
- Population Growth
- Inflation
- Insufficient Demand for Primary Products
- Mounting Debt Burden

17) Discuss the measures to correct disequilibrium in Balance of Payments.

Ans. There are two types to correct disequilibrium--

- Monetary Measures:
    i. Deflation
    ii. Exchange Depreciation
    iii. Devaluation
    iv. Adjustments through Capital Movement
    v. External Debts or Foreign Aid
- Non-Monetary Measures:
    i. Trade Controls-
        a. Import tariffs
        b. Quotas
        c. Export Promotion and Import substitution
    ii. Exchange Controls-
        a. Exchange licensing method
        b. Multiple exchange rate

18) Elaborate the role of Multinational Companies/ Corporations.

Ans. MNCs invest in other countries, but do not have coordinated product offerings in each country.

- Such companies have offices and /or factories in different countries and usually have a centralized head office where they co-ordinate global management.
- Very large budget—more than small countries
- Officially designated by United Nations as "transnational corporations" or TNCs.
- Positive role (advantages)-
    i. Direct employment
    ii. Indirect Employment
    iii. FDI

iv. Technology
v. Higher income
vi. Foreign networking and access to foreign market
vii. Skills
viii. Externalities
ix. Competitiveness
x. Higher productivity
xi. Environment friendly technologies
xii. Infrastructure

- Negative role (disadvantages)-
  i. Monopoly power
  ii. Limited skill development
  iii. Profits are repatriated in foreign exchange
  iv. Environmental damage
  v. Loss of revenue
  vi. Exploitation
  vii. Inappropriate techniques of production and products

19) Write a short note on gains from trade.

Ans. Gains from trade are the benefits from trading rather than producing.

- Gains are—
  i. Efficient utilization of resources
  ii. Increase in production
  iii. Increase in consumer choice of products
  iv. Widening of market
  v. Increase in competition
  vi. Increase in National income
  vii. Reduction in cost due to economies of scale
  viii. Increase in welfare

20) Write a short note on purchasing power parity

Ans. Developed by Swedish economist Gustave Casell

- Identical goods sold in different markets will sell at same price when expressed in terms of a common currency.
- Theory assumes that the market structure is competitive and no transportation cost
- Two versions:
  - Absolute – the absolute rate of exchange determined by absolute prices
    - R= P/P*
    - R—exchange rate, P—price of basket of goods in domestic currency, P*--price of identical basket in the foreign currency
  - Relative— changes in prices in both the countries and analyses its impact on the exchange rate.
    - $R1= R_0 \text{ X } P_1/P_2$

21) Give arguments in favour of free trade.

Ans. Free trade Policy is one in which there are no restrictions on trade in terms of tariffs, quotas, exchange control, etc.

- Arguments:
  i. Promotes comparative cost advantage
  ii. Optimum utilization of resources—efficiency
  iii. Increased standard of living
  iv. Availability of variety of goods
  v. Lower the cost of production through economies of scale
  vi. Increased competition—prohibits the growth of monopolies and exploitation
  vii. Diffusion of technology
  viii. Increased productivity—quality products at reasonable prices to consumers

22) Discuss the merits and demerits of fixed exchange rate.

Ans. Merits-

- Promotes International Trade and Investments
- Imparts discipline in macroeconomic policies
- Promotes international cooperation
- Promotes domestic stability
- No need for frequent changes
- Avoids destabilizing speculation

Demerits-

- Leads to domestic inflation and deflation
- Does not permit independent and internal policies
- Need for large foreign exchange reserve
- Does not react quickly to market forces
- Not necessarily favourable to international investment and lending.