ECO401- Final Term

Subjective



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What is meant by non price competition?

Non price competition means competition amongst the firms based on factors other than price, e.g. advertising expenditure, product differentiation etc

What is meant by exchange rate? Also give example of exchange rate

The price of one country's currency expressed in another country's currency. In other words, the rate at which one currency can be exchanged for another.

For example, the higher the exchange rate for one Dollar in terms of one r=Rupee, the lower the relative value of the Rupee

Exchange rate (also known as the foreign-exchange rate, forex rate or FX rate)

Why government needs to revalue its currency?

Revaluation of Currency is the act of increasing the price (exchange rate) of one nation's currency in terms of other currencies. Government revalues its currency to raise the price of the country's exports and lower the price of foreign imports.

Procedure for revaluation is for the government to buy the nation's currency and/or sell foreign currencies through the foreign exchange market.

Write the key variables for macro economic model

The key variables for a macroeconomic model are:
Y = Income
C = Consumption
S = Savings
I = Investment
T = Taxes
G = Government Expenditures
M = Imports
X = Exports

Circular flow of goods and income for firms and households

Circular flow of income describes the movement of money throughout the economy between producers and consumers. It is a continuous flow of production, income and expenditures. Circular flow of income producers receive the amount what consumers spend. All expenditures from consumers/individuals become the income of the producers, and the expenditures of the producers become the income of the consumers/individuals.

What is the reason of poverty in developing countries according to Prebisch-Singer hypothesis? 3 - Marks

Reason of poverty in developing countries according to Prebisch-Singer hypothesis

- They were stuck in the production of primary products
- Lack of human, social and public capital
- Very fast rising populations
- Lack of natural resources (like oil, gold, gas, iron, copper etc.)

Discuss the components on the assets and liabilities side of the balance sheet of a central bank

Assets side of SBP's balance sheet,
(1) The country's foreign exchange reserves (foreign currencies, gold and silver reserves; either held domestically or invested abroad)
(2) Credit to government: this would include any SBP lending to government, including in the form of any outstanding (i.e. yet to mature) treasury bonds and bills lying with the SBP
(3) Credit to banks: this would include any advances (another name for loans) extended by SBP to commercial banks.
Liabilities side of SBP's balance sheet,
4) Notes and coins in circulation (i.e. M0). Note that for a currency-issuer (SBP in our case), the currency is a liability, not an asset;
(5) Government or banks' deposits: these would include any positive account6 balances held by commercial banks and/or the government;
(6) Outstanding liquidity paper issued: this would include any bills issued by the central bank for the purpose of mopping up liquidity from the financial system.

PAST SUBJECTIVE

Why Marginal Revenue and price are equal under perfect competition?

In perfect competition a firm that changes the quantity they sell does not affect price, therefore marginal revenue is equal to price.

On what factors steady state growth rate of real GDP depends? (3)

The steady-state growth rate of real GDP depends on n and t, the exogenous rates of growth of population and technology

When does real wage unemployment occur in an economy? (3)

Classical or real-wage unemployment occurs when real wages for a job are set above the market-clearing level. This is often as a result of government intervention, as with the minimum wage, or unions

MPC = 0.84 and tax rate = 0.27 then find tax-adjusted multiplier

Tax multiplier = 1/ (1- MPC (1 – t))

Tax multiplier = 1/ (1- 0.84 (1 – 0.27))

Tax multiplier = 1/ (0.16 (0.73)

Tax multiplier = 1/ 0.1168

Tax multiplier = 8.57

Difference between Residential Investment and Inventory Investment

Residential investment includes the purchase of new housing both by people who plan to live in it themselves and by landlords who plan to rent it to others.

Inventory investment, the goods that businesses put aside in storage, is at the same time negligible and of great significance.

Fiscal policy under flexible exchange rate

With flexible exchange rates, the output level is determined in the money market where the interest rate is set equal to the world interest rate. Any change in government policy will only affect the exchange rate.

Make balance sheet of central bank

Balance sheet of SBP

Balance sheet of SBP	
Assets	**Liabilities**
Forex reserves	Notes, coins & currency in circulation: M0
Loans/Credit to Govt	Govt & commercial bank deposits
Loans/Credit to private sector	Liquidity paper issued

Discuss the concept of accelerator in your own words

The **accelerator** is a reverse concept of multiplier which formalizes the investment response to output or income changes in an economy. When an economy begins to recover from a slump, investment can rise very rapidly and, in percentage terms, the rise in investment may be several times the rise in income. Since investment is an injection into the circular flow of income, these

changes in investment will cause multiplied changes in income and thus heighten a boom or deepen a recession.

The formula for the accelerator is $\alpha = I/(\Delta Y)$, or $(\Delta K)/(\Delta Y)$

Define fiscal policy

The Government income and expenditures policy is known as fiscal policy

Differentiate between expansionary and contractionary fiscal policy

Expansionary fiscal policy:

An increase in government spending and decrease in taxes is called expansionary fiscal policy. According to policy higher government spending /decrease tax will increase aggregate demand.

Its simply the increase in government spending and reduce taxes.

Contractionary fiscal policy

A decrease in government spending and increase in taxes is called contractionary fiscal policy.

An active policy tries to stabilize output by using monetary and/or fiscal policy. A passive policy does not.

Its simply the increase in taxes and reduce government spending

Question No: 49 (Marks: 3)

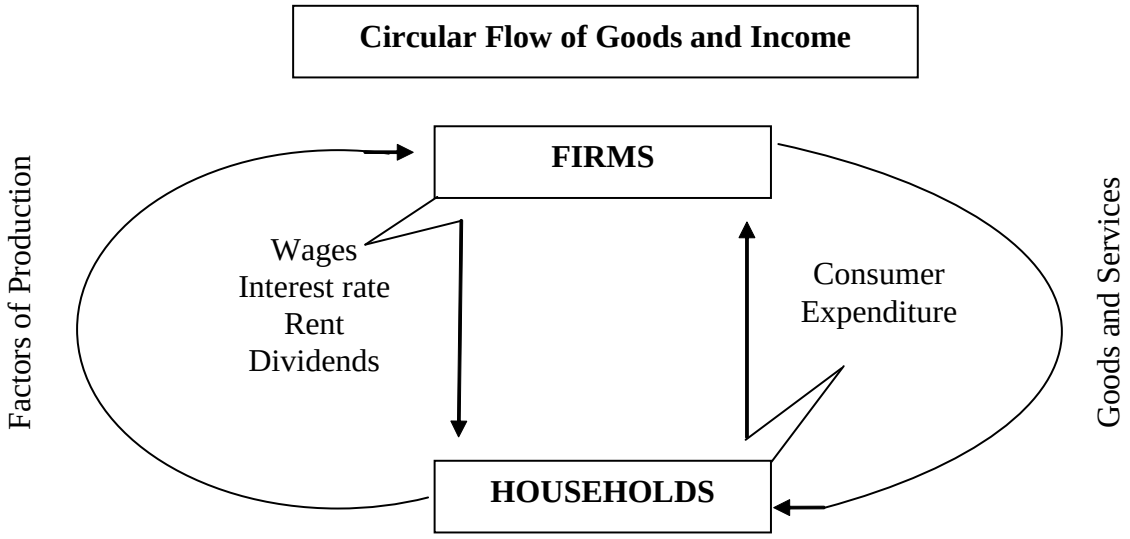
It is said that growth is an important macroeconomic issue. Why? Discuss.

Growth is an important macroeconomics issue because every country wants to achieve higher growth rate. Higher growth rate indicates the better living standards and high national income.

Growth can be attained through trade e.g. a developing country who have specialization in a good and also have comparative advantage. By exporting these goods developing country can increase its national income and also attract foreign investment.

Question No: 52 (Marks: 5)

Following figure shows the circular flow of goods and income in a two sector economy. Interpret all the points in this figure that how the household sector and business sector work in an economy to produce goods and services.



Circular flow of income describes the movement of money throughout the economy between producers and consumers. It is a continuous flow of production, income and expenditures. Circular flow of income producers receive the same amount what consumers spend. All expenditures from consumers/individuals become the income of the producers, and the expenditures of the producers become the income of the consumers/individuals.

Question No: 53 (Marks: 5)

Explain the difference between current account and capital account.

Current Account:

Current account is one of the two components of balance of payments. Current account shows the difference between a nation's total exports of goods, services and transfers, and its total imports.

Capital Account:

The capital account generally provides a direct picture of the net asset position of a country vis-à-vis the rest of the world. The capital account contains foreign direct investment (FDI), portfolio

investment and other investments, plus changes in the reserve account. The capital account and the current account together comprise a nation's balance of payments

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Question No: 57 (Marks: 5)

Some economists suggest "growth through resource transfer" and "growth through stabilization and reforms" strategies to tackle the problem of poverty of under developed countries. What is the basic theme of both these strategies? Discuss.

Answer :

Growth through resource transfer strategy states that money funds should be given to poor countries and this money should also be utilized properly. Through this process, private capital flows and foreign direct investment can also be made. When foreign firms came in the local market, they will bring skill and capital with themselves which will promote local market. But the problem with this strategy is that aid flows causes heavy debt burden for the poor countries.

Growth through stabilization and reforms strategy states that there should be privatization and liberalization policies adopted in developing countries. Good governance and administrative reforms should be implemented. International Monetary Fund (IMF) and the World Bank (WB) became involved in macroeconomic stabilization and structural reform.

Question No: 56 (Marks: 5)

Explain the difference between Gross National Product (GNP) and Net National Product (NNP) with the help of their formulas.

Gross National Product (GNP)

Gross national product (GNP) is the value, at current market prices, of all final goods and services produced during a year by the factors owned by the citizens of a country

GNP = GDP + Net factor incomes from abroad

Net National Product (NNP)

Mathematically, national income is net national product (NNP). It is GNP adjusted for depreciation.

NNP = GNP – Depreciation allowance

According to the values given in the following table, calculate the injections at each level of output.

Output (Y)	Saving (S)	Gross Imports (M)	Gross investment (I)	Gross exports (X)	Govt. Expenditures (G)	Taxes (T)
650	80	80	104	97	116	10
700	90	80	119	97	116	10
750	100	80	130	97	116	10
800	110	80	139	97	116	10
900	120	80	146	97	116	10

Withdrawal = Injection

S + T + M = I + G + X

Injection = I + G + X

Injection =104+116+97 = 317

Injection =119+116+97 =332

Injection =130+116+97 = 343

Injection =139+116+97 =352

Injection =146+116+97 = 359

Total injection =1403

Question No: 51 (Marks: 5)
Why is taxation necessary? What are the principles of taxation?

Taxation is necessary because government collects taxes are to get the revenue needed to finance public goods and pay administrative expenses.
Without taxes, the government would not be able to deliver services like law and order, public administration, national defense, free or subsidized health and education etc

Equity principle

Equity represents that principle of taxation which emphasizes fairness or just sacrifice, i.e. everyone should pay tax according to his/her ability

Vertical equity principle

Progressive taxation, in which the tax rate increases as income increases, is an application of the vertical equity principle

Horizontal equity principle

A less controversial principle relates to horizontal equity which says: identically well-off people should be taxed identically, i.e. no discrimination due to race, gender, caste, religion etc.

Interest parity condition

a) What is interest parity condition?

Interest parity shows the relationship between the currency exchange rates of two countries and their local interest rates, and the essential role that it plays in foreign exchange markets.

b) When does this condition hold?

This condition holds if there are no incentives to move the capital from one country to another country as the difference between them

c) What is the equation of this condition?

$iD \approx iF + \Delta Ee$

Domestic interest rate = Foreign interest rate + Expected depreciation

Question No: 55 (Marks: 3)

What are the different components of aggregate demand? Discuss briefly

Aggregate demand (AD) is the total planned or desired spending (expenditure) in the economy during a given period.

Components of AD are: consumption, investment, government spending and net exports (i.e. exports minus imports)

From the information given in the following table, calculate the number of unemployed persons and unemployment rate.

Year	Size of Labor Force	Number of persons Employed
1984	113544	105005
1985	115461	107150
1986	117834	109597
1987	119865	112440

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1988	121669	114968

Unemployed person

Unemployed person in 1984 = 113544 -105005 =8539
Unemployed person in 1985 = 115461 -107150 =8311
Unemployed person in 1986 = 117834 -109597 =8237
Unemployed person in 1987 = 119865 -112440 =7425
Unemployed person in 1988 = 121669 -114968 =6701

Unemployment rate

Unemployment rate = (Number of unemployed / labour force) x 100
1984 = 8539/113544 x 100 =7.5%
1985= 8311/115461 x 100 =7.2%
1986=8237/117834 x 100 =6.9%
1987=7425/119865 x 100= 6.1%
1988=6701/121669 x 100 =5.5%

Question No: 57 (Marks: 5)

Differentiate between final goods and intermediate goods with the help of examples.

Final goods

Final goods are meant for direct use by the end consumer rather than for further processing.

Example:

- Car sold is the final good
- flour used by a household is a final good

Intermediate goods

Intermediate goods are those that are intended for further processing

Example:

- Parts of car are the intermediate good.
- Flour used by a baker is an intermediate good

A. See the following table:

Year	1979	1980	1981	1982	1983	1984	1985	1986
Real GDP Growth Rate	1.2%	-5.5%	1.8%	3.9%	4.5%	5.3%	2.6%	1.9%

a) Calculate the average growth rate from 1982 and 1985.

3.9 %+4.5%+5.3%+2.6% / 4

=16.3% / 4

= 4.0%

b) Calculate the average growth rate from 1979 and 1986.

1.2 % - 5.5% +1.8% +3.9%+4.5% +5.3%+2.6%+1.9% / 8

=21.2% - 5.5% / 8

=15.7% / 8

=1.96%

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Question No: 53 (Marks: 5)

Why could the world as a whole not experience a problem of a current account balance of payments deficit?

The world as a whole not experience a problem of a current account balance of payments deficit because every import to one country is an export from another, and every outflow of investment income or transfer of money from one country is an inflow to another. Thus when all the current account deficits and current account surpluses of all the countries of the world are added up, they must all cancel each other out.

Question No: 49 (Marks: 3)

Differentiate between real exchange rate and nominal exchange rate.

Nominal exchange rate means the number of units of the domestic currency that can purchase a unit of a given foreign currency.

For example, 100 Pakistani rupees can purchase one US dollar. If 100 Pakistani rupee can buy two US dollar then we can say there nominal appreciation of the currency.

The real exchange rate means how many of a good or service in one country can be traded for one of that good or service in another country.

For example, a real exchange rate might state how many Pakistani fans can be exchanged for one US fan.

Question No: 52 (Marks: 5)

Differentiate between fixed exchange rate and floating exchange rate.

Floating Exchange Rate

A floating is one where currencies are allowed to move freely up and down according to changes in demand and supply. A currency that uses a floating exchange rate is known as a floating currency

Fixed Exchange Rate

Exchange rate under which the government or central bank fixed the official exchange rate to another country's currency. Also known as pegged exchange rate.

Difference b/w Real and Nominal GDP

Real GDP:

Real Gross Domestic Product measures the value of all the goods and services produced expressed in the prices of some base year.

Nominal GDP:

Nominal GDP measures the value of all the goods and services produced expressed in current prices. Nominal GDP is measured on current prices for goods and services paid by buyers.

Difference b/w demand push inflation and cost push inflation?

Cost push inflation

Cost push inflation is a phenomenon in which the general price levels rise (inflation) due to increases in the cost of wages and raw materials.

Demand pull inflation

Demand pull inflation is that occurs when price levels raise because of an imbalance in the aggregate supply and demand. When the aggregate demand in an economy strongly offsets the aggregate supply, prices increase. Economists will often say that demand-pull inflation

Differentiate b/w actual GDP and potential GDP

Potential GDP

The potential GDP of a country is the ideal or maximum possible GDP for that country if unemployment is at a minimum and operating at maximum possible output

Actual GDP

The actual GDP of a country is the real, or actual, value of all goods and services produced.

GDP gap = (Actual GDP − potential GDP) / Potential GDP
The percentage GDP gap is the actual GDP minus the potential GDP divided by the potential GDP.

(A) Following are the items of balance sheet of bank A

Loans = 80

Deposits = 100

Reserves = 20

Prepare the balance sheet in proper form and find out total assets and total liabilities.

Solution:

Balance sheet of bank A	
Assets	**Liabilities**
Loans = 80	Deposits =100
Reserves =20	
Total assets = 100	Total liabilities = 100

(B) Following are the items of balance sheet of bank A

Loans = 60

Deposits = 110

Reserves = 50

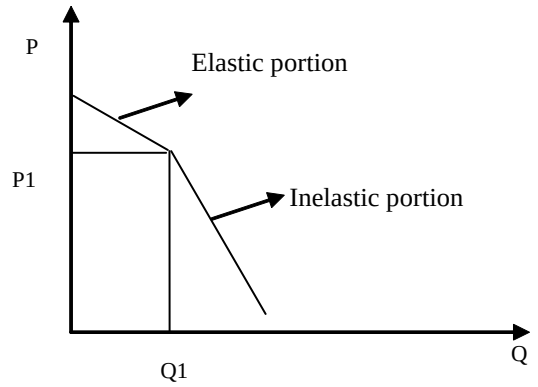
Firm A deposits Rs. 50 in bank A. Prepare the balance sheet in proper form and find out total assets and total liabilities after the deposits of firm A.

Balance sheet of bank A	
Assets	**Liabilities**
Loans = 60	Deposits =110
Reserves =50	
Total assets = 110	Total liabilities = 110

After deposit 50 Rs Balance sheet of Bank A

Balance sheet of bank A	
Assets	**Liabilities**
Loans = 60	Deposits =110 +50 =160
Reserves =50 +50	
Total assets = 160	Total liabilities = 160

IF reserve requirement is given then take that % age as reserve



(A) The above demand curve has two distinct segments which have different elasticities that join to form a corner or kink. Why the firms are reluctant to change the price in these two segments?

The firm is reluctant to raise it prices because demand is relatively elastic above the kinked Rise in prices cause fall in sales because other not rise there price and customer switch to lower price products Price increase only decrease the revenue for the firm

Firm is reluctant to fall its prices because the demand is relatively inelastic below the kinked. Fall in prices bring only modest increase in sale and other fall there prices too so customer not switch and firm reluctant to fall its prices.

(B) What are the major advantages that an oligopoly offers for public interests?

Price stability may bring advantages to consumers and the macro-economy

Question No: 50 (Marks: 3)

On what basis countries gain from trade?

Countries gains from trade due to the comparative advantage. Countries which have comparative advantage in the production of particular goods exports that good to another country that has comparative disadvantage in that good.

Question No: 51 (Marks: 5)

A. "Slope of the consumption function is less than 1".What is meant by this statement?

The slope is merely the MPC. The intercept is positive because some consumption must happen even at a zero level of income (people will borrow and spend on food for e.g.), and the slope is less than 1 because not all the income is consumed

B. What are the major macroeconomic variables involved in the determination of national income?

Major macroeconomic variables involved in the determination of national income are C, I, G, X, M, T, S, prices, exchange rate, interest rate and money supply.

What does the 45 degree line in expenditure-income space represent?

It represents all the points at which the economy is in equilibrium, i.e. the expenditure on domestic goods and services is equal to the supply of domestic goods and services is equal to the incomes distributed to actors used in the production of those goods and services

Functions of Central Bank:

Monetary policy is just one of the functions of the central bank. There are at least three more functions central banks serves:

1-As lender of last resort, it must bail (or help) out commercial banks facing temporary liquidity shortfalls;

2- as supervisor of the financial system, it must ensure its good health by monitoring commercial banks' lending (risk-taking), capital adequacy, and liquidity positions. The central bank is also a monitor of the management and governance of financial institutions and of any other threats to the stability of the financial system;

3-**As the biggest intervener in the foreign exchange market** (and/or setter of the exchange rate), it is responsible for exchange rate policy and the balance of payments, per se.

Discount rate: the central bank sometimes extends credit to commercial banks on their request to meet their exigent liquidity needs.7 Such borrowing is called borrowing from the discount window and the rate the central bank lends at the discount window is called the discount rate

Question No: 49 (Marks: 3)

Write down the functions of commercial banks.

They take deposits (i.e. borrow money) and make loans (i.e. lend money). The interest rate they pay on deposits is lower than the interest rate they charge on their loans. The difference covers their overhead costs and profits

Question No: 50 (Marks: 3)
How the growth rate of output is determined in the exogenous growth model?

Growth rate of output is determined by the growth rate of population which is exogenously given and Government can not do anything about it.

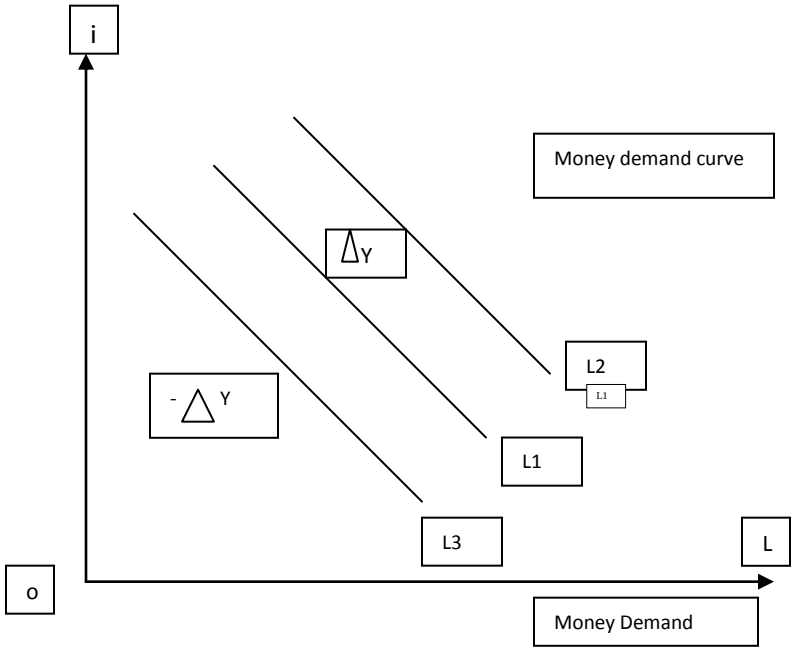
Question No: 50 (Marks: 3)

Differentiate between international trade and international finance.

International trade is the exchange of goods and services between different countries and International finance is concerned with, among other thing, the mobility of financial capital across countries, and the problems and opportunities this mobility presents individual countries with.

Question No: 50 (Marks: 3)

Explain the shape of money demand curve with the help of diagram.



- Increase in income by + ΔY cause money demanded to increase at any level of interest money demand curve shift form L1 to L2
- Reduction in income by - ΔY money demanded curve shift from L1 to L3 quantity demanded of money fall

Question No: 51 (Marks: 5)

How can a current account, which is in deficit, be restored to balance under fixed exchange rate regimes?

Current account is very much important in order to maintain the long term sustainability of the balance of payment.
Current account deficit = Private sector resource deficit + Government budget deficit

Devaluation can help in reducing current account deficit. Devaluation causes an increase in exports and decrease in imports leading to reduction in current account deficit. Economic deflation is another solution to this problem under fixed exchange rate regime.

Question No: 49 (Marks: 3)

Mention the transactions that cause the demand for dollars to increase in the foreign exchange market.

- Pakistani imports of US goods.
- Pakistani travelers traveling to the US.
- Pakistani students paying for study in US universities.
- profits send back to US by US firms operating in Pakistan

Differentiate between transaction motive and precautionary motive of holding money.

Transactions demand/Motive: People hold money to buy stuff.
Precautionary demand/Motive: People hold money for emergencies

Demand for Money
Transactions demand. People hold money to buy stuff.
Precautionary demand. People hold money for emergencies
Speculative demand. People hold money to take advantage of a financial opportunity at a later date

Question No: 52 (Marks: 5)

What are the major weaknesses of exogenous growth theory? Which theory was developed in against of exogenous growth theory?

Exogenous growth theory suffered from three major weaknesses:

i. It could not explain why the gap between the poor and rich countries had widened (anticatch up),
ii. It could not explain why some countries in East Asia had apparently grown consistently on the back of higher saving rates, and
iii. It modeled technology as exogenous, and beyond the influence of policy

Endogenous growth theory or **new growth theory** was developed in against of exogenous growth theory

In economics, **endogenous growth theory** or **new growth theory** was developed in the 1980s as a response to criticism of the neo-classical growth model

Question No: 52 (Marks: 5)

Identify which of the following are stock variables and which are flow variables?

a) Unemployment **Stock**
b) Redundancies (job lay-offs) **Flow**
c) Profits **Flow**
d) A firm's stock market valuation (share price) **Stock**
e) The value of property after a period of inflation **Stock**

Question No: 53 (Marks: 5)

World Bank suggests some structural reform policies for the poor countries to grow. Discuss those policies briefly

World Bank has given 4 types of liberalization policies as an ingredient.

1. **Liberalization of prices**: Removal of price control and wage controls.
2. **Liberalization of trade**: Removal of tariffs and export taxes.
3. **Liberalization of capital account** means movement of capital from inside and outside the country.
4. **Financial liberalization** i.e. financial sector should be opened both to foreign participation and also banks should be allowed to set their own interest rate rather than government dictating what the interest level should be.

Question No: 49 (Marks: 3)

Differentiate between inflation and deflation.

Inflation is a situation in which there is a continuous rise in the general price level.
Deflation is the opposite of inflation and occurs when the general level of prices falls.

Pure inflation is a special case of inflation in which the prices of all the goods and services in the economy are rising at the same rate.

Question No: 50 (Marks: 3)

What are the reasons that poor countries remained poor?

- Do not have enough human capital and because of lack of education
- Poor countries exports cotton, rice, wheat, raw material which face declining price in international market.
- Term of trade of developing countries was deteriorating. decline terms of trade

OR

- They were stuck in the production of primary products
- Lack of human, social and public capital
- Very fast rising populations
- Lack of natural resources (like oil, gold, gas, iron, copper etc

What is the reason of poverty in developing countries according to Prebisch-Singer hypothesis? 3 - Marks

Reason of poverty in developing countries according to Prebisch-Singer hypothesis

- They were stuck in the production of primary products
- Lack of human, social and public capital
- Very fast rising populations
- Lack of natural resources (like oil, gold, gas, iron, copper etc.)

What are the different method of measuring GDP

There are three equivalent ways of measuring GDP:
i. The product or value added method which sums the value added by all the productive entities in the economy;
ii. The expenditure method which sums up the value of all the "final goods" transactions taking place in the economy;
iii. The factor income method which sums up all the incomes earned by all the factors of production in the economy (rent for land, wages for labour, interest for capital, and equity returns for entrepreneurship).

Question No: 50 (Marks: 3)

What are the different borrowing options available to the government for reducing the fiscal deficit?

By borrowing locally (i.e. issuing bonds), foreign financing (including non-relpayable grants) or printing money (i.e. borrowing from the central bank). The first of these methods is least inflationary while the last one is most inflationary

Question No: 51 (Marks: 5)

Explain the difference between endogenous growth model and exogenous growth model.

Exogenous

The development of an economy is not only dependent on the internal affairs of a company; rather the external matters also make effect upon it. Under exogenous growth (comprehensive development) it is estimated on the primary basis that which external factors play the role of development of economy in comparison to internal factor

Endogenous

Endogenous growth (limited development) is a kind of policy under which the emphasis is laid down on the internal process and capital investment rather than external factors. Under this policy, an emphasis is laid down on internal factors for the economic growth and development rather than external factors.

Question No: 52 (Marks: 5)

What are the conditions in which foreign exchange market exists? Also give some examples of foreign exchange markets.

A foreign exchange market exists because economies utilize national currencies. If the world economy used a single currency there would be no need for foreign exchange markets.
Foreign exchange market is a market in which currencies of different countries are traded. For example, Foreign exchange markets are made up of banks, commercial companies, central banks, investment management firms etc. The Foreign exchange market is considered to be the largest financial market in the world.

BEST OF LUCK

