ECO401 Subjective Material

Question No: 55 (Marks: 3)
According to Keynesian school of thought, what should be the role of government in order to bring the economy out of depression?
Answer No: 55
Keynes introduced demand-pull theory which emphasizes strongly the intervention
of government into economy.
According to him economy may be boosted up by increasing expenditure. In the
initial stage government can inject money in the form of investment and higher wage
rate to the government employees. This will create higher demand which in return
result in more investment by firms.
Question No: 56 (Marks: 5)
In the above figure, suppose the economy is on the horizontal portion of aggregate supply (AS) curve.
a) If government expenditures increase, what will happen to the
27
aggregate expenditure line E, aggregate demand curve AD and output level Y.
Answer No: 56 (a)
It will cause more short run demand in the economy and "e" will move to the right
in P-Y space.
It will increase the consumption part of injection as well and "e" will move upward
and right in W.J-Y space.
AD will curve will move to right in P-Y space resulting increasing short run output
"Y".
b) Is there any multiplier effect? How it works in this case?
Answer No:56 (b)

Yes, multiplier effect exists there.
Keynes multiplier 1/mps is the variable which determines the injection level
to
create an hypothetical desired output.
(Marks: 3+2)
Question No: 57 (Marks: 5)
World Bank suggests some structural reform policies for the poor countries
to grow. Discuss those policies briefly.
Answer No: 57
These are also called IMF's Stabilization Policies. These were concluded
from
neoclassical economics, known since 1990.
The objective of IMF was to ensure both through internal balance
(supply=demand,
i.e. low inflation, full employment) and
external balance (sustainable BOP and external debt position).
The approach was "stabilization" through "demand" management.
There are three tools of this policy as follows!

• Tight Monetary Policy
• Tight Fiscal Policy
• Devaluation

IMF Policies effected LIC's badly. There was a very high criticism on above
said
policies. The main points of criticism were as follows!
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• Short-term policy conflicts
• Devaluation could raise prices of imports.
• Demand-reduction policies are anti-growth: increased taxation can stifle
the
productive sector.
• Stabilization hurts the poor expenditure cuts almost always fall partly on
the
social sectors.

Question No: 58 (Marks: 10)
Recall the Equation of Quantity theory of money and calculate the missing
figure in each of the following cases:
a) Money supply (M) =100, Price (P) = 3 and real output (Q) = 200.
Calculate the missing figure.

Answer No: 58 (a)
MV = PQ
100xV = 3 x 200
V = 600 / 100
V = 6
b) Velocity of money (V) = 4, Price (P) = 5 and output (Q) =100.
Calculate the missing figure.
Answer No: 58 (b)
MV = PQ
M x 4 = 5 x 100
M = 500 / 4
M = 125
c) Money supply (M) = 200, velocity of money (V) = 7 and output (Q) = 700. Calculate the missing figure.
Answer No: 58 (c)
MV = PQ
200 x 7 = P x 700
P = 1400 / 700
P = 2
d) Money supply (M) =150, velocity of money (V) = 8, Price level (P) =
29
3. Calculate the missing value.
Answer No: 58 (d)
MV = PQ
150 x 8 = 3 x Q
Q = 1200 / 3
Q = 400
(Marks: 2.5 each)

Question No: 51 (Marks: 5)
Briefly discuss the private cost of advertising. How we can calculate the marginal social cost?
ANSWER: Private Cost Of Advertising: The private cost of advertising is the
cost incurred by firm in making the advertisement i.e newspaper adds, tv commercials etc. The firms do not take into account the nuisance faced by
41
people due to these advertisements otherwise the firms would do less

advertisement.
Marginal Social Cost: Marginal social cost is not a monetary based cost. It is the cost borne by the society as a whole. It is the cost of consumption of one next unit.
Question No: 52 (Marks: 10)
A. What conclusions are derived from exogenous growth theory?
ANSWER: Exogenous Growth Theory: The major conclusions derived from the exogenous growth are as follows:
I The steady growth rate of real GDP depends on exogenous rates of growth of population (n) and technology (t). There are no policies for government for how to affect the steady growth rate of a country. Higher savings can only have a little effect on income it cannot cause long term growth because savings cause diminishing returns to investment and capital accumulation.
I If one country started with lower income and capital than another country, the poorer country will grow faster to catch up the richer country and then both the countries will grow together.
B. What is meant by convergence theory? Explain the convergence theory in the given graph.
(Marks: 4+6)
Question No: 53 (Marks: 10)
Define fiscal policy. Differentiate between contractionary and expansionary fiscal policy. In which situations, budget deficit and budget surplus exist?
Answer: Fiscal Policy: Fiscal policy is the government's about the
• expenditure in form of purchases, subsidies and interest payments on debt etc.
• revenue in form of taxes etc.
Difference between Contractionary and Expansionary Fiscal Policy:
Contactionary Fiscal Policy Expansionary Fiscal Policy
42
In conactionary fiscal policy
government decreases its expenditure.
In expansionary fiscal policy
government increases its expenditure.
Budget Deficit and Budget Surplus: Budget deficit exists if government expenditure increases the revenue earned. In this case government needs to finance its expenditure through borrowing.

Budget surplus exists when revenue exceeds the government expenditure. In this condition government can easily pay off its debt borrowings.
(Marks: 2+4+4)
Question No: 54 (Marks: 10)
Discuss the basic theories regarding IMF's stabilization program. Are these theories successful? If not, give reasons.
Answer: IMF's Stabilization Theories:
I Tight Fiscal Policy: It works through higher revenues and reduced government expenditure.
I Devaluation: Switching from imports to home produced goods. It increases competitiveness, exports and increase investors confidence in local currency.
I Tight Monetary Policy: Higher interest rates resulting in reduced private sector consumption and investment demand. It reduces inflation and increases savings. High interest rates also results in higher capital inflow.
Theses theories are generally not successful in lower income countries (LICs).
Because they caused the problems of:
• Devaluation: It raises the price of imports and also increased the inflation while the real wage rate could not increase.
• Stabilization hurts poor: decrease in expenditure always badly effects the poor which
can then cause political instability

Question No: 53 (Marks: 10)
Define M0 and M1. Briefly discuss the three broad motives of holding money.
(Marks:4+6)
Question No: 54 (Marks: 10)
Recall the Equation of Quantity theory of money and calculate the missing figure in each of the following cases:
a) Money supply (M) =100, Price (P) = 3 and real output (Q) = 200. Calculate the missing figure.
b) Velocity of money (V) = 4, Price (P) = 5 and output (Q) =100. Calculate the missing figure.
c) Money supply (M) = 200, velocity of money (V) = 7 and output (Q) = 700. Calculate the missing figure.

d) Money supply (M) =150, velocity of money (V) = 8, Price level
(P) = 3. Calculate the missing value.(Marks: 2.5 each)

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 repatriated to
US by US firms operating in Pakistan.
Question No: 50 (Marks: 3)
Why countries have comparative advantage according to Ricardo?
Comparative advantage according to Ricardo:
The law of **comparative advantage** refers to the ability of a party (an individual,
a firm, or a country) to produce a particular good or service at a lower
opportunity cost than another party. There is a source of comparative advantage
can be productivity differentials.Ricardo argued that there is mutual benefit from
trade (or exchange) even if one party **(e.g. resource rich country, highly-skilled**
artisan) is more productive in every possible area than its trading counterpart

(e.g. resource-poor country, unskilled laborer), as long as each concentrates on
the activities where it has a relative productivity advantage
Question No: 51 (Marks: 5)
A.
"Slope of the consumption function is less than 1".What is meant by this
statement?
When we drawn in expenditure income space, the consumption function plots as
a straight line with positive intercept, and a positive but less than 1 slope.

The slope is less than 1 because not all the income is consumed some part of the
income is saved.

B. What are the major macroeconomic variables involved in the determination of national income?
(Marks: 2+3)

C, I, G, X, M, T, S, prices, exchange rate, interest rate and money supply.

Question No: 52 (Marks: 5)

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

In a market there are buyers and sellers who negotiate and agree on the price for
the or
price for the commodity being exchanged. The foreign exchange market is no
different.
whatever, here the commodity being traded is foreign exchange and the price is
the foreign exchange rate. Specifically, a foreign currency is being traded for the
Pakistani Ruppee at a particular rate of exchange.
The sellers and buyers of foreign exchange are not mutually exclusive. The
sellers of today, may be the buyers of tomorrow, or even of today.
Foreign exchange market exists when **buyers and sellers** exit and ready to sell
and buy.
The **main driving force** for foreign exchange market is the law of supply and
demand.

Examples are US $-PAK RS Foregin exchange market
US $ - UK POUND Foregin exchange market

Question No: 53 (Marks: 5)

What thing determines comparative advantage among countries according to Hechshcer-Ohlin? What is the criticism against their argument?

According to Hechshcer-Ohlin suppose we are given two countries one abundant
in labour and one abundant in capital and a labour-intensive good and a capital
intensive
good, the labour abundant country will have comparative advantage in the production of the labour-intensive good while the capital abundant country will
have comparative advantage in the capital-intensive good.
So the determinants of comparative advantage among countries according to Hechshcer-Ohlin is capital goods and labour intensive goods.
Critics argued that comparative advantage can and should be viewed in a dynamic (time-varying) sense, and that it was not wise to rule out the possibility
of Pakistan developing comparative advantage in cars at some future point in time.
Consequent:
The major criticism leveled against Hechscher-Ohlin type trade theories are that
they views
comparative advantage in an essentially static sense; i.e. if Pakistan is better at
producing
cotton and Japan better at producing, then this situation will always prevail.

Question No: 49 (Marks: 3)
Define balance of payment (BOP). How the BOP can be determined?
Answer:
A BOP is a sheet in other words an account sheet which is an accounting record of
all monetary transactions between a country and the rest of the world.
These transactions include
Payments for the country's exports and imports of goods, services,
and financial capital, as well as financial transfers.
The BOP summarizes international transactions for a specific period, usually a year,
and is prepared in a single currency, typically the domestic currency for the country concerned.

Surplus items:
Sources of funds for a nation, such as exports or the receipts of loans and investments, are recorded as positive/surplus items.
Deficit items:
Uses of funds, such as for imports or to invest in foreign countries, are recorded as a
negative or deficit item.
It can be determined if we see the things in both prespective.In other words it is a
non-complicated way, lets assume that we have two countries Pakistan and united
states and things are viewed from Pakistan point of view.
For this purpose we must now the market for foreign exchange. Foreign exchange
in a Pakistani context means US $ and in a US point of view it is Pak rupees.

Question No: 50 (Marks: 3)
Explain the shape of money demand curve with the help of diagram.
Answer:
Money demand Md increases with income levels.
Money demand Md falls with interest rates.
In this concept we are talking about real income and real interest rate not the nominal income and nominal interest rate.
So this implies to the demand of real money.
Whether nominal and real money supply is equal or not depends much on the
assumption regarding prices. If prices are assumed fixed, then the two are equal,
otherwise not.
As you can see from the diagram where money demand in on the x-axis and income is on the y-axis, and there are various level showns like L1,L2,L3.
i
Money demand
curve
Y
L2
- Y
L1

L3
L
o
Money Demand

Question No: 51 (Marks: 5)
How can a current account, which is in deficit, be restored to balance under
fixed exchange rate regimes?
Answer:
There is solution for how can a current account which is in deficit be restored to
balance under fixed exchange rate regimes. The answer is **"Economic Deflation"**
Economic Deflation says When a country's national income rises, it spends more;
part of that spending falls on imported goods; higher imports cause the current
account to worsen.
The reverse is also true for this lower income must reduce import spending and
therefore improve the current account spending.
However, economic contraction is not a good idea to restore current account
equilibrium the other alternative solution presented by economist is to devaluate or
"devaluation".
Devaluation is the phenomena related to exchange rate where exchange rate faces
depreciation but in the context of fixed exchange rates. The complement of
devaluation is revaluation.
A concept of devaluation is to bring the exchange rate in line with its long-run
equilibrium level, i.e. a level consistent with international competitiveness.
Competitiveness is simply defined as the real exchange rate RER, where RER =
(Pf/Pd)*NER. Where
NER
Pf

Pd
Nominal Exchange rate
is the price level prevailing in the foreign country (US)
is the price level prevailing in the home country (Pakistan).
The formula implies that, for a fixed NET if inflation is higher in Pakistan (relative to the US), Pakistani exports will become less attractive in the international market. As

a result, our exports will fall, and current account will go into deficit.
To fix this problem, the NER can be devalued so as to make our goods cheaper and competitive and it is to bring competitiveness back to its original higher level.
However, there are many provisos attached to the devaluation policy prescription.
Devaluation only works if the country's exports and imports are elastic, otherwise the price effect of the devaluation will dominate the volume effect and the current account will worsen. Secondly, the country must have excess productive capacity in order to meet the higher demand for exports that is created as a result of the devaluation. Thirdly, the country should not have a very high foreign debt whose burden increases so much as a result of the devaluation that the negative effects associated therewith overwhelm any positive competitiveness effects.

Capital account (+ or -)

+
-
+
-
Incoming FDI, FPI or other private capital
Outgoing FDI, FPI or other private capital
Borrowing, aid inflows

Payments of debt principal, aid outflows

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

(Marks: 1 for each)

Question No: 53 (Marks: 5)

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

Ans:

World Bank has suggested following policies for the poor countries to grow,

1.

Governance and administrative reforms: To reduce over employment in public sector, reduce wastes and to improve the quality and reliability of public services. To strengthen the administration of taxes, to eliminate the corruption. To

decentralize the control of fiscal policy making. To enrich the legal and regulator framework.

2.

Privatization of state-owned enterprises: Abbreviated as SOEs. These are influenced by political interference and it is one of the reasons SOEs are considered inefficient. SOEs are also suffering form lack of competition, cost awareness and fear of bankruptcy.

3.

Financial liberalization: It involves ending of financial repression policies including artificially low interest rates, credit rationing, restrictions on banking

competition and government involvement in investment allocation
4.
5.
6.
Liberalization of prices, removal of subsidies
Deregulation involving dismantling of licensing systems and red-tape
Trade liberalization: including tariffication of non-tariff-barriers, harmonization of tariffs and an eventual reduction thereof
7.
FDI liberalization: To create a transparent, predictable environment for foreign investors to operate in.
8.
Capital account liberalization: To remove controls on capital flows
These policies are suggested by world bank and the successful implementation of
these policies depend on the political and economic system of poor countries. In
general these policies are expected to provide the poor nation with better understanding and help them to raise their growth.

ECO401 CURRENT PAPERS SUBJECTIVE

Question No: 49 (Marks: 3)

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

Answer:

EXCHANGE RATE:

Rate at which one currency may be converted into another. The exchange rate is used when simply converting one currency to another (such as for the purposes of travel to another country), or for engaging in speculation or trading in the foreign exchange market. There are a wide variety of factors which influence the exchange rate, such as interest rates, inflation, and the state of politics and the economy in each country.**also called** rate of exchange or foreign exchange rate or currency exchange rate.

EXAMPLE:
An exchange rate of 123 Japanese yen (JPY, ¥) to the United States dollar

(USD, $) means that JPY 123 is worth the same as USD 1.

Question No: 50 (Marks: 3)
What is the reason of poverty in developing countries according to Prebisch-Singer
hypothesis?

ANSWER:

POVERTY means the state of being poor; lack of the means of providing material needs or comforts.

According to Prebisch-Singer hypothesis following are the reason of poverty in developing countries:

- One of the reson for poverty is increasing population.
- Another reason **Lack of precious natural resources (like oil, gold, gas, iron, copper etc.)** was also cited by some as the reason for LICs' continued poverty.

Question No: 51 (Marks: 5)

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

(Marks: 1 for each)

ANSWER:
We know:
INJECTION=I+X+G
SO,
the injections at each level of output=
1-317

2-332

3-343

4-352

5-359

Question No: 52 (Marks: 5)

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

ANSWER:

EXOGENOUS GROWTH THEORY:

The Exogenous growth model, also known as the Neo-classical growth model or Solow growth model is
a term used to sum up the contributions of various authors to a model of long-run economic growth
within the framework of neoclassical economics.

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.

PART B SOLUTION:

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 OR exogenous growth theory

Question No: 53 (Marks: 5)

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

ANSWER:

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

ASSET SIDE COMPONENTS:

- Loans to Govt Notes
- Forex reserves
- Loans to private sector

LIABILITY SIDE COMPONENTS:

- Notes, coins & currency in circulation
- Govt & commercial bank deposits
- Liquidity paper issued

Question No: 49 (Marks: 3)

Define balance of payment (BOP). How the BOP can be determined?

ANSWER:

THE BALANCE OF PAYMENTS (BOP):

BOP is an accounting record of a country's transactions with the rest of the world.

The balance of payments (or BOP) measures the payments that flow between any individual country and all other countries. It is used to summarize all international economic transactions for that country during a specific time period, usually a year.

PART B SOLUTION:

How the BOP can be determined?

IT CAN BE DETERMINED IN THE FOLLOWING WAY:

The BOP is determined by the country's exports and imports of goods, services, and financial capital, as well as financial transfers. It reflects all payments and liabilities to foreigners (debits) and all payments and obligations received from foreigners (credits).

Balance of payments is one of the major indicators of a country's status in international trade, with net capital outflow.

Question No: 50 (Marks: 3)

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

Answer:

PERFECT ANSWER ON THIS LINK IS AVAILABLE SEE THIS(PG 9 AND PG 10)
http://www.ssc.wisc.edu/~ldrozd/my_files/102files/slides_9.pdf

Question No: 51 (Marks: 5)

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

Answer:

There is solution for how can a current account which is in deficit be restored to balance under fixed exchange rate regimes. The answer is
"Economic Deflation"
Economic Deflation says When a country's national income rises, it spends more; part of that spending falls on imported goods; higher imports cause the current account to worsen.
The reverse is also true for this lower income must reduce import spending and therefore improve the current account spending.
However, economic contraction is not a good idea to restore current account equilibrium the other alternative solution presented by economist is to devaluate or "devaluation".
Devaluation is the phenomena related to exchange rate where exchange rate faces depreciation but in the context of fixed exchange rates. The complement of devaluation is revaluation.
A concept of devaluation is to bring the exchange rate in line with its long-run equilibrium level, i.e. a level consistent with international competitiveness.

Question No: 52 (Marks: 5)

Identify which of the following are stock variables and which are flow variables?
hese are the terms used to differentiate things like "wealth versus income" or

"debt versus deficit."

That is, a "stock variable" is a variable measurable at one particular time (wealth); whereas, a "flow variable" is a variable measured after a prolonged amount of time retrospecting spending in the past "x" amount of time (income).

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

(Marks: 1 for each)

ANSWER:

DEFINITION IS JST FOR CONCEPT NOT THE ANSWER.

These are the terms used to differentiate things like "wealth versus income" or "debt versus deficit."

That is, a "stock variable" is a variable measurable at one particular time (wealth); whereas, a "flow variable" is a variable measured after a prolonged amount of time retrospecting spending in the past "x" amount of time (income).

REQUIRED ANSWER:

FOLLOWING ARE THE STOCK VARIABLES:

- Unemployment
- A firm's stock market valuation (share price)
- The value of property after a period of inflation
-

FOLLOWING ARE THE FLOW VARIABLES:

- Redundancies (job lay-offs)
- Profits

Question No: 53 (Marks: 5)

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Ans:

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To reduce over employment in public sector, reduce wastes and to improve the quality and reliability of public services. To strengthen the administration of taxes, to eliminate the corruption. To decentralize the control of fiscal policy making. To enrich the legal and regulator framework.
Privatization of state-owned enterprises:
Abbreviated as SOEs. These are influenced by political interference and it is one of the reasons SOEs are considered inefficient. SOEs are also suffering form lack of competition, cost awareness and fear of bankruptcy.
Financial liberalization:
It involves ending of financial repression policies including artificially low interest rates, credit rationing, restrictions on banking competition and government involvement in investment allocation
Deregulation involving dismantling of licensing systems and red-tape
Trade liberalization:
including tariffication of non-tariff-barriers, harmonization of tariffs and an eventual reduction thereof
FDI liberalization:
To create a transparent, predictable environment for foreign investors to operate in.
apital account liberalization:
To remove controls on capital flows

(These policies are suggested by world bank and the successful implementation of these policies depend on the political and economic system of poor countries. In general these policies are expected to provide the poor nation with better understanding and help them to raise their growth.)

Question No: 50 (Marks: 3)

Differentiate between international trade and international finance.
ANSWER:
By **international trade**, we mean the exchange of goods and services between different countries.

International trade is the trade between two or more different countries. It is just the opposite of the trade that takes place within a country i.e. national trade.

Whereas **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. It would
not be too inaccurate (in present day context) to say that while international trade deals with the current
account, international finance deals with the capital account of the BOPs. That said, issues like the
choice of exchange rate regime and of modern-day balance of payments crises also fall firmly within the
purview of international finance.

Question No: 51 (Marks: 5)

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

ANSWER:

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

ASSET SIDE COMPONENTS:

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- Forex reserves
- Loans to private sector

LIABILITY SIDE COMPONENTS:

- Notes, coins & currency in circulation
- Govt & commercial bank deposits

Liquidity paper issued

Question No: 53 (Marks: 5)

If y = Y / L, where, Y = Total GDP, L = Population, y = Per capita GDP then prove that Growth rate of per capita income = Growth rate of total output - Growth rate of population

ANSWER:
y = Y / L
Where,
• Y = Total GDP
• L = Population
• y = Per capita GDP
Taking log of both sides
• ln y = ln Y – ln L
Taking derivative *w.r.t.* time
• 1/y (dy/dt) = (dY/dt)/Y – (dL/dt)/L
gy = gY – gL

Growth rate of per capita income = Growth rate of total output - Growth rate of population
<u>REFRENCE:</u>
CHP NO 38 PAGE NO 168

Question No: 49 (Marks: 3)

Differentiate between inflation and deflation.
ANSWER:
Inflation is a situation in which there is a continuous rise in the general price level.
WHEREAS **Deflation** is the opposite of inflation and occurs when the general level of prices falls.

Inflation is when the money supply increases by more than the real economy does. This means that one unit of currency will buy less than it could in the past.
Deflation is when the money supply contracts, making a unit of currency able to buy more than it could in the past. This is the exact opposite of inflation, but it is also bad.

Question No: 50 (Marks: 3)

What are the reasons that poor countries remained poor?

Question No: 51 (Marks: 5)

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

Question No: 52 (Marks: 5)

EXOGENOUS GROWTH THEORY

The Exogenous growth model, also known as the Neo-classical growth model or Solow growth model is
a term used to sum up the contributions of various authors to a model of long-run economic growth
within the framework of neoclassical economics

ENDOGENOUS 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.
In neoclassical growth models, the long-run rate of growth is exogenously determined by assuming a
savings rate (the Solow model) or a rate of technical progress. This does not explain the origin of
growth, which makes the neo-classical model appear very unrealistic. Endogenous growth theorists see
this as an over-simplification

Following table shows different stages of production of cloth. Calculate the value added at each stage of production. What is GDP by this approach?

Stage of production	Money value (Rs)	Value added at each stage (Rs)
Raw cotton	10.50	?
Cotton yarn	25.68	?
Coarse cloth	45.82	?
Finished cloth	55.66	?

ANSWER:

Stage of production	Money value (Rs)	Value added at each stage (Rs)
Raw cotton	10.50	10.50
Cotton yarn	25.68	15.18

Coarse cloth	45.82	20.14
Finished cloth	55.66	9.84

<u>REFERENCE</u>

METHODS 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).

Value added is the difference between the value of goods produced and the cost of materials and
supplies used in producing them. Value added consists of the wages, interest and profit components
added to the output by a firm. Value added is the difference between inputs and outputs e-g if a firm
spends Rs.500 making a good (inputs) and sells its product (output) for Rs.750, then value added is
Rs.250.

Question No: 53 (Marks: 5)

Discuss the equilibrium condition in money market. Explain this equilibrium condition with the help of diagram.

ANSWER= CHP NO 43

Question No: 49 (Marks: 3)

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

Discuss.

ANSWER:

Why Growth is an Important Macroeconomic Issue:

It is obvious why growth is an important macroeconomic issue. Every government aspires to deliver a
higher growth rate for the country. High growth rates means higher national income which means better
living standards on average, which in democracies, means happier electorates and therefore increased
chances of re-election for another term in office. However, while all countries might wish to achieve
high growth rates, in practice, only a handful have been able to convert the wish into reality.

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: 52 (Marks: 5)

Differentiate between fixed exchange rate and floating exchange rate.

ANSWER:

Fixed exchange rate:

.A fixed exchange rate means the amount of currency received is set in advance.

A fixed exchange rate is based upon the government's view of the value of its currency as well as the monetary policy. It has advantages. Stability is one. Another is predictability. Businesses and individuals can plan their activities with the certainty of the value of money. A businessman shipping goods overseas knows the value in advance. A tourist travelling in other countries can budget knowing what his money will buy.

Floating exchange rates:

A floating exchange rate means that the rate is moving and the currency received depends on the time of the exchange

.The floating exchange rate, in its true form, allows the marketplace to set the rate. The forces of supply and demand determine the value of a currency.

For example, when the US dollar is considered strong it will take more euros, the currency of most European countries, to buy. When the US dollar is considered weak or in decline the amount of euros needed to buy it will fall.

Question No: 53 (Marks: 5)

Some economists suggest "growth through trade strategy" to tackle the problem of poverty of under developed countries.

a) **What is the basic theme of this strategy?**
b) **Why this strategy is not so much successful?**
c) **What is the proposed solution presented to tackle the drawback of this strategy?**

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 repatriated to
US by US firms operating in Pakistan.

Question No: 50 (Marks: 3)

Why countries have comparative advantage according to Ricardo?

ANSWER:

<u>Comparative advantage according to Ricardo:</u>

The law of **comparative advantage** refers to the ability of a party (an individual, a firm, or a country) to produce a particular good or service at a lower opportunity cost than another party. There is a source of comparative advantage can be productivity differentials.Ricardo argued that there is mutual benefit from trade (or exchange) even if one party **(e.g. resource rich country, highly-skilled artisan**) is more productive in every possible area than its trading counterpart (e.g. resource-poor country, unskilled laborer), as long as each concentrates on the activities where it has a relative productivity advantage

Question No: 51 (Marks: 5)
A.

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

ANSWER:
When we drawn in expenditure income space, the consumption function plots as a straight line with positive intercept, and a positive but less than 1 slope. The slope is less than 1 because not all the income is consumed some part of the income is saved.

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

(Marks: 2+3)

Following are the major macroeconomic variables involved in the determination of national income :

C, I, G, X, M, T, S, prices, exchange rate, interest rate and money supply.

Question No: 52 (Marks: 5)

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

In a market there are buyers and sellers who negotiate and agree on the price for the or
price for the commodity being exchanged. The foreign exchange market is no different.
whatever, here the commodity being traded is foreign exchange and the price is the foreign exchange rate. Specifically, a foreign currency is being traded for the Pakistani Ruppee at a particular rate of exchange.
The sellers and buyers of foreign exchange are not mutually exclusive. The sellers of today, may be the buyers of tomorrow, or even of today.
CONDITION:

Foreign exchange market exists when **buyers and sellers** exit and ready to sell and buy.
The **main driving force** for foreign exchange market is the law of supply and demand.

EXAMPLE:

US $-PAK RS Foregin exchange market
US $ - UK POUND Foregin exchange market

Question No: 53 (Marks: 5)

What thing determines comparative advantage among countries according to Hechshcer-Ohlin? What is the criticism against their argument?

According to Hechshcer-Ohlin suppose we are given two countries one abundant
in labour and one abundant in capital and a labour-intensive good and a capital intensive
good, the labour abundant country will have comparative advantage in the production of the labour-intensive good while the capital abundant country will have comparative advantage in the capital-intensive good.
So the determinants of comparative advantage among countries according to Hechshcer-Ohlin is capital goods and labour intensive goods.
Critics argued that comparative advantage can and should be viewed in a dynamic (time-varying) sense, and that it was not wise to rule out the possibility of Pakistan developing comparative advantage in cars at some future point in time.

Consequent:

The major criticism leveled against Hechscher-Ohlin type trade theories are that they views
comparative advantage in an essentially static sense; i.e. if Pakistan is better at producing
cotton and Japan better at producing, then this situation will always prevail.

Question No: 49 (Marks: 3)

Differentiate between inflation and deflation.

ANSWER:

Inflation is a situation in which there is a continuous rise in the general

price level.
WHEREAS **Deflation** is the
opposite of inflation and occurs when the general level of prices falls.

Inflation is when the money supply increases by more than the real economy does. This means that one unit of currency will buy less than it could in the past.
Deflation is when the money supply contracts, making a unit of currency able to buy more than it could in the past. This is the exact opposite of inflation, but it is also bad.

(Marks: 5)

What is meant by Philips Curve? Explain the shape of this curve with the help of diagram.
Philips Curve
W.A.Philips gave the idea of Keynes a formalized shape and draws the Philips curve stating inverse
relationship between unemployment and inflation rate.
Philips's views were consistent with the Keynesian views. The cost of reducing inflation is
unemployment and the cost of reducing unemployment is inflation
DIAGRAM
For diagram take a look on chp#34 page no 149.
(I DON,T HV MICROSOFT WORD IN MY PC THATS Y GRPAH CAN,T BE DRAW HERE)

Question No: 53 (Marks: 5)

How crowding out of investment demand occur due to expansionary fiscal policy?

ANSWER CAN BE:

In economics, **crowding out** is any reduction in private consumption or investment that occurs because of an increase in government spending. If the increase in government spending is financed by a tax increase, the tax increase would tend to reduce private consumption. If instead the increase in government spending is not accompanied by a tax increase, government borrowing to finance the increased government spending would increase interest rates, leading to a reduction in private investment, although there is no empirical evidence that supports such interest rate effect on investment

1. Comments of current account in balance of payment 3 marks
ANSWER:
THE CURRENT ACCOUNT
The current account balance is essentially the trade balance (exports minus imports), but with net factor
receipts from abroad added.
If the exchange rate is fixed, then changes in reserves must mirror the combined balance on the current
and capital accounts in order to bring the overall BOPs to zero. If the exchange rate is floating, then
changes to reserves can remain zero, as the adjustment burden is borne by the exchange rate which
appreciates (depreciates) in response to a joint surplus (deficit) on the current and capital accounts.
REFRENCE FOR COMPLETE CONCEPT:
PARTS OF BOP
The BOPs can be divided into three parts:
i. Current account,
ii. Capital account and
iii. Changes to reserves

2. **The reason of poverty in developing countries according Perbisch-Singer Hypothesis**
(3 marks)
ANSWER:

POVERTY means the state of being poor; lack of the means of providing material needs or comforts.

According to Prebisch-Singer hypothesis following are the reason of poverty in developing countries:

- One of the reson for poverty is increasing population.
- Another reason **Lack of precious natural resources (like oil, gold, gas, iron, copper etc.)** was also cited by some as the reason for LICs' continued poverty.

3. Pull demand inflation, cost push inflation (5 marks)
ANSWER:
<u>DEMAND PULL INFLATION:</u>

The inflation resulting from an increase in aggregate demand is called **demand-pull inflation**. Such an inflation may arise from any individual factor that increases aggregate demand, but the main ones that generate *ongoing* increases in aggregate demand are :

Increases in the money supply

Increases in government purchases

Increases in the price level in the rest of the world

<u>COST PUSH INFLATION:</u>

Inflation can result from a decrease in aggregate supply. The two main sources of decrease in aggregate supply are

- An increase in wage rates
- An increase in the prices of raw materials

These sources of a decrease in aggregate supply operate by increasing costs, and the resulting inflation is called **cost-push inflation.**

4. **What are the comparative advantages between countries according Hechshcer-Ohlin? And criticisms against it.**

ANSWER:
According to Hechshcer-Ohlin suppose we are given two countries one abundant
in labour and one abundant in capital and a labour-intensive good and a capital intensive
good, the labour abundant country will have comparative advantage in the production of the labour-intensive good while the capital abundant country will have comparative advantage in the capital-intensive good.
So the determinants of comparative advantage among countries according to Hechshcer-Ohlin is capital goods and labour intensive goods.
<u>Critics argued</u> that comparative advantage can and should be viewed in a dynamic (time-varying) sense, and that it was not wise to rule out the

possibility of Pakistan developing comparative advantage in cars at some future point in time.

Consequent:

The major criticism leveled against Hechscher-Ohlin type trade theories are that they views
comparative advantage in an essentially static sense; i.e. if Pakistan is better at producing
cotton and Japan better at producing, then this situation will always prevail

1.components of current account of BOPS:
ANSWER:

Following are the components:
1.GOODS
2.SERVICES
3.INCOME
4.CURRENT ACCOUNT.
(FOR COMPLETE UNDERSTANDING AND MORE COMPONANTS VISIT THIS LINK)
http://www.investopedia.com/articles/03/061803.asp

:
1**. Difference between capital deepening and capital widening(5 MARKS)**
ANSWER:

Capital deepening

is a term used in economics to describe an economy where capital per worker is increasing. It is an increase in the
capital intensity. Capital deepening is often measured by the capital stock per labour hour.Overall, the
economy will expand, and productivity per worker will increase. However, economic expansion will not
continue indefinitely through capital deepening alone. This is partly due to diminishing returns and wear
& tear

capital widening:

is a term used to describe the situation where capital stock is increasing at the

same rate as the labour force, thus capital per worker remains constant. The economy will expand in
terms of aggregate output, but productivity per worker will remain constant

2 .Difference between GNP and NNP:(5 MARKS)
ANSWER:
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. Thus the income earned by
Pakistani citizens working in the US would be included in Pakistan’s GNP but excluded from Pakistan’s
GDP. Conversely, the income earned by a US citizen (individual or corporate) in Pakistan would be
included in Pakistan’s GDP but excluded from Pakistan’s GNP. Generally, GNP = GDP + net factor
income from abroad. The abbreviation for gross national product, which is the total market value of all
goods and services produced by the citizens of an economy during a given period of time, usually one
year. Gross national product often was once the federal government's official measure of how much
output our economy produces.
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. In
words, it is the net output of commodities and services flowing during the year from the country’s
production system in the hands of ultimate consumers. The total market value of all final goods and
services produced by citizens of an economy during a given period of time, usually a year, after
adjusting for the depreciation of capital. Net national product, abbreviated NNP, has the same relation to
net domestic product (NDP) as gross national product (GNP) has to gross

domestic product (GDP). Net
national product also has the same relation to gross national product that net domestic product has to
gross domestic product. Like NDP, NNP is a measure of the net production in the economy.
NNP = GNP – Depreciation allowance

3. Explain Comparative advantage among contries according to Hechshcer-Ohlin. And criricism on it?
ANSWER:
According to Hechshcer-Ohlin suppose we are given two countries one abundant
in labour and one abundant in capital and a labour-intensive good and a capital intensive
good, the labour abundant country will have comparative advantage in the production of the labour-intensive good while the capital abundant country will have comparative advantage in the capital-intensive good.
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Consequent:
The major criticism leveled against Hechscher-Ohlin type trade theories are that they views
comparative advantage in an essentially static sense; i.e. if Pakistan is better at producing
cotton and Japan better at producing, then this situation will always prevail.

Q # 1 Difference between inflation and deflation? Marks 3
ANSWER:
Inflation is a situation in which there is a continuous rise in the general price level.
WHEREAS **Deflation** is the
opposite of inflation and occurs when the general level of prices falls.

Inflation is when the money supply increases by more than the real economy does. This means that one unit of currency will buy less than it

could in the past.
Deflation is when the money supply contracts, making a unit of currency able to buy more than it could in the past. This is the exact opposite of inflation, but it is also bad.

Q # 2 How the central banks plays its important role in order to control the activities of commercial banks? Marks 3

central bank, **reserve bank**, or **monetary authority** is a banking institution granted the exclusive privilege to lend a government its currency. Like a normal commercial bank, a central bank charges interest on the loans made to borrowers, primarily the government of whichever country the bank exists for, and to other commercial banks, typically as a 'lender of last resort'. However, a central bank is distinguished from a normal commercial bank because it has a monopoly on creating the currency of that nation, which is loaned to the government in the form of legal tender. It is a bank that can lend money to other banks in times of need. Its primary function is to provide the nation's money supply,

Q # 3 Difference between depreciation and appreciation of currency? Marks 5

ANSWER:

<u>Depreciation:</u>

This is a more or less permanent decrease in value or price. "More or less permanent" doesn't include
temporary, short-term drops in price that are common in many markets. It's only those price declines
that reflect a reduction in consumer satisfaction.While all sorts of stuff can depreciate in value, some of
the more common ones are capital, real estate, corporate stock, and money

<u>APPRECIATION</u>

This is a more or less permanent increase in value or price. "More or less permanent" doesn't include
temporary, short-term jumps in price that are common in many markets. Appreciation is only those
price increases that reflect greater consumer satisfaction and thus value.

While all sorts of stuff can
appreciate in value, some of the more common ones are real estate, works of art, corporate stock, and
money.

Q # 4 what is meant by laffer curve? Also explain the shape of this curve? Marks 5

ANSWER:

The graphical inverted-U relation between tax rates and total tax collections by government is known as
Laffer curve. This curve is developed by economist Arthur Laffer; the Laffer curve formed a key
theoretical foundation for supply-side economics of President Reagan during the 1980s. It is based on
the notion that government collects zero revenue if the tax rate is 0% and if the tax rate is 100%. At a
100% tax rate no one has the incentive to work, produce, and earn income, so there is no income to tax.
As such, the optimum tax rate, in which government revenue is maximized, lies somewhere between 0%
and 100%. This generates a curve shaped like an inverted U, rising from zero to a peak, and then falling
back to zero. If the economy is operating to the right of the peak, then government revenue can be
increased by decreasing the tax rate.

(AGAIN FOR DIAGRAM VISIT PAGE NO 175 OF CHP # 40)

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

ANSWER:

When we drawn in expenditure income space, the consumption function plots as a straight line with positive intercept, and a positive but less than 1 slope. The slope is less than 1 because not all the income is consumed some part of the income is saved.

Differentiate between Inflation and deflation. **Marks3**

ANSWER:
Inflation is a situation in which there is a continuous rise in the general price level.
WHEREAS **Deflation** is the
opposite of inflation and occurs when the general level of prices falls.
Inflation is when the money supply increases by more than the real economy does. This means that one unit of currency will buy less than it could in the past.
Deflation is when the money supply contracts, making a unit of currency able to buy more than it could in the past. This is the exact opposite of inflation, but it is also bad

Question No: 49 (Marks: 3)

Define balance of payment (BOP). How the BOP can be determined?

Answer:
A BOP is a sheet in other words an account sheet which is an accounting record of all monetary transactions between a country and the rest of the world.

These transactions include
→ Payments for the country's exports and imports of goods, services, and financial capital, as well as financial transfers.

The BOP summarizes international transactions for a specific period, usually a year, and is prepared in a single currency, typically the domestic currency for the country concerned.

Surplus items:
Sources of funds for a nation, such as exports or the receipts of loans and investments, are recorded as positive/surplus items.

Deficit items:
Uses of funds, such as for imports or to invest in foreign countries, are recorded as a negative or deficit item.

It can be determined if we see the things in both prespective.In other words it is a non-complicated way, lets assume that we have two countries Pakistan and united states and things are viewed from Pakistan point of view.

For this purpose we must now the market for foreign exchange. Foreign exchange in a Pakistani context means US $ and in a US point of view it is Pak rupees.

Question No: 50 (Marks: 3)

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

Answer:

Money demand Md increases with income levels.

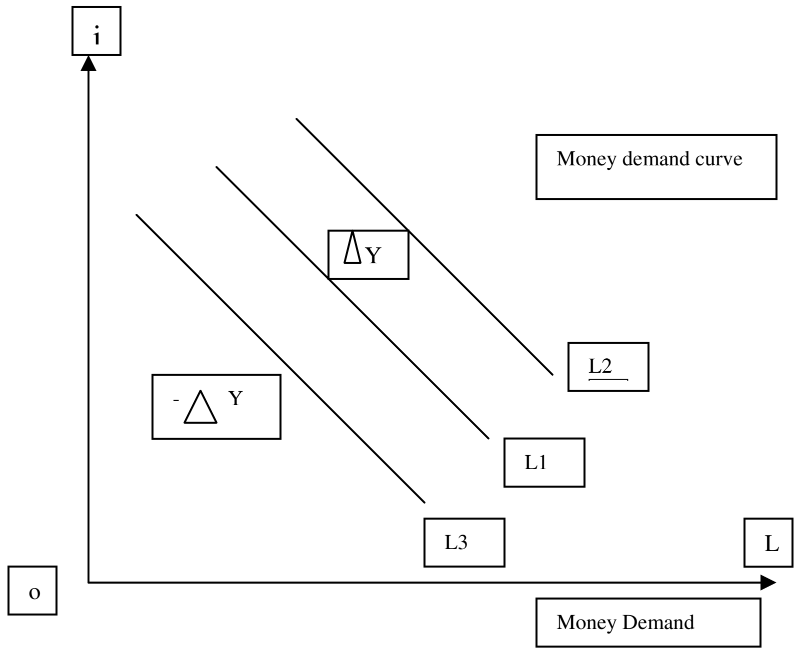
Money demand Md falls with interest rates.

In this concept we are talking about real income and real interest rate not the nominal income and nominal interest rate.

So this implies to the demand of real money.

Whether nominal and real money supply is equal or not depends much on the assumption regarding prices. If prices are assumed fixed, then the two are equal, otherwise not.

As you can see from the diagram where money demand in on the x-axis and income is on the y-axis, and there are various level showns like L1,L2,L3.



Question No: 51 (Marks: 5)

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

Answer:

There is solution for how can a current account which is in deficit be restored to balance under fixed exchange rate regimes. The answer is **"Economic Deflation"**

Economic Deflation says When a country's national income rises, it spends more; part of that spending falls on imported goods; higher imports cause the current account to worsen.

The reverse is also true for this lower income must reduce import spending and therefore improve the current account spending.

However, economic contraction is not a good idea to restore current account equilibrium the other alternative solution presented by economist is to devaluate or “devaluation”.

Devaluation is the phenomena related to exchange rate where exchange rate faces depreciation but in the context of fixed exchange rates. The complement of devaluation is revaluation.

A concept of devaluation is to bring the exchange rate in line with its long-run equilibrium level, i.e. a level consistent with international competitiveness.

Competitiveness is simply defined as the real exchange rate RER, where RER = (Pf/Pd)*NER. Where

NER → Nominal Exchange rate

Pf → is the price level prevailing in the foreign country (US)
Pd→ is the price level prevailing in the home country (Pakistan).

The formula implies that, for a fixed NET if inflation is higher in Pakistan (relative to
the US), Pakistani exports will become less attractive in the international market. As a result, our exports will fall, and current account will go into deficit.

To fix this problem, the NER can be devalued so as to make our goods cheaper and competitive and it is to bring competitiveness back to its original higher level. However, there are many provisos attached to the devaluation policy prescription.

Devaluation only works if the country’s exports and imports are elastic, otherwise the price effect of the devaluation will dominate the volume effect and the current account will worsen. Secondly, the country must have excess productive capacity in order to meet the higher demand for exports that is created as a result of the devaluation. Thirdly, the country should not have a very high foreign debt whose burden increases so much as a result of the devaluation that the negative effects associated therewith overwhelm any positive competitiveness effects.

Capital account (+ or -)
+ → Incoming FDI, FPI or other private capital
- →Outgoing FDI, FPI or other private capital
+ → Borrowing, aid inflows
- →Payments of debt principal, aid outflows

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**

(Marks: 1 for each)

Question No: 53 (Marks: 5)

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

World Bank has suggested following policies for the poor countries to grow,

1. **<u>Governance and administrative reforms:</u>** To reduce over employment in public sector, reduce wastes and to improve the quality and reliability of public services. To strengthen the administration of taxes, to eliminate the corruption. To decentralize the control of fiscal policy making. To enrich the legal and regulator framework.

2. **<u>Privatization of state-owned enterprises:</u>** Abbreviated as SOEs. These are influenced by political interference and it is one of the reasons

SOEs are considered inefficient. SOEs are also suffering form lack of competition, cost awareness and fear of bankruptcy.

3. **Financial liberalization:** It involves ending of financial repression policies including artificially low interest rates, credit rationing, restrictions on banking competition and government involvement in investment allocation

4. **Liberalization of prices, removal of subsidies**

5. **Deregulation involving dismantling of licensing systems and red-tape**

6. **Trade liberalization:** including tariffication of non-tariff-barriers, harmonization of tariffs and an eventual reduction thereof

7. **FDI liberalization:** To create a transparent, predictable environment for foreign investors to operate in.

8. **Capital account liberalization:** To remove controls on capital flows

These policies are suggested by world bank and the successful implementation of these policies depend on the political and economic system of poor countries. In general these policies are expected to provide the poor nation with better understanding and help them to raise their growth.