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**(Part A)**

**MCQ’s**

1. **(A) State Bank**
2. **(B) Keynesian Economist**
3. **(B) Public Employment Project**
4. **(C) Fiscal Policy**
5. **(A) Increases Reserve Requirement**
6. **(B) Three Reasons**
7. **(B) Exporters**
8. **(A) Reserve Ratio**
9. **(B) Recession**
10. **(C) Hyper Inflation**

**(PART B)**

**Q1: Differentiate between: (5x3=15)**

* **Disinflation And Hyperinflation**

**Disinflation**

Disinflation is a non-permanent slowing of the pace of price inflation (price inflation is an increase of price level across the economy). Disinflation is used to show illustrations when the inflation rate reduces marginally over the short term. Disinflation is a condition where inflation is still positive, but the rate of inflation is decreasing, for example from +3% to +2%.

**Hyperinflation**

Hyperinflation is a rapid inflation (increase in the price level across the economy), typically more than 50% in a single month. Hyperinflation can breakdown the economy of the country and its monetary system. Best example where hyperinflation occurred is Germany where in 1923, the prices rose upto to 2500% in a month.

* **Central Bank And Commercial Bank**

**Central Bank**

A central bank is a financial organization or institution given authority control over the production and distribution of money and credit for a nation or a group of nations. It is mainly responsible for the formulation of monetary policy and the regulation of member banks. Most of the central banks (not all) are owned and controlled by government. Examples include Federal Reserve Bank (U.S.), the European Central Bank (EU) and the Bank of Japan (Japan).

**Commercial Banks**

A commercial bank is a financial body that performs the functions of accepting deposits from the general public and ensuring loans for investment with intention to earn profit. Most countries mainly have commercial banks. Examples of commercial banks in Pakistan include Allied Bank Limited, Askari Bank, Bank Alfalah, Bank AL Habib etc.

* **Demand Pull And Cost Push Inflation**

**Demand Pull Inflation**

It is a situation that is caused by consumers where the aggregate demand continuously exceeds the available supply of output at current prices which causes the general price level to go up. Here the the demand is high in the market but supply is less, so the sellers increase the price of products. It main causes include population growth, construction of houses, heavy spending on events and increase in wages etc.

**Cost Push Inflation**

It is situation that is caused by producers, where level of prices increase or rise due to increase in cost of production and this situation is called as cost push inflation. The business organizations do it in order to secure their business margins. The main causes of cost push inflation include increase in wages, increase in prices of raw materials and imported inflation etc.

* **Expansionary And Contractionary Fiscal Policy**

**Expansionary Fiscal Policy**

Expansionary fiscal policy is also called as expansive fiscal policy. The policy supports aggregate demand growth and in turns the growth of total output or production. This growth of total output leads to an expansion in the amount of money in the economy. The economy uses expansion fiscal policy when the country the economy slows i.e. recession.

**Contractionary Fiscal Policy**

Contractionary fiscal policy is also called as restrictive fiscal policy. This policy is based to lessen the inflation rate by the means of limiting both the aggregate demand and supply. The economy uses contractionary fiscal policy during inflation in order to reduce the inflation rate.

* **Open Market Operation And Discount Rate.**

**Open Market Operations**

Open-market operations are activities that are conducted by open central banks when they buy or sell the government securities like bonds, T-bills etc. in the market. The general public, govt., businesses are the bodies to which the central banks sell these government securities and from them they purchase it too. The money supply increases, when they buy government bonds and the money supply decreases, when they sell government bonds.

**Discount Rate**

The discount rate is the interest rate the Central Bank (State bank) charges commercial banks and the government for loans. Increasing the discount rate decreases the money supply and decreasing the discount rate increases the money supply.

**Q2: (a) Briefly define money and discuss few of its functions. (5+5)**

**Money**

Money is basically everything which the people use for exchange.

**OR**

Money is set of assets that people daily use to buy goods and services from other people.

**OR**

Money is any verifiable item that is generally accepted as medium to buy goods and services from other people.

**Functions of Money**

Money basically has three core functions that are described as follows,

1. **Medium of Exchange**

Money functions as medium of exchange when it is used to intermediate the exchange of good and services.

1. **Unit of Account**

It is a criterion unit of measurement of market value of goods, services, and other transactions. To function as a unit of account, money must be divisible into smaller units without losing its value, it must be exchangeable and it must be with a proper certain size or weight to be verifiable countable. It is basically the yardstick people use to post prices and record debts.

1. **Store of Value:**

In order to act as store value, money must be reliably stored, saved and recovered. Here the value of money must be stable over a specific period of time and it must be usable whenever it is retrieved.

**Or**

An item people can use to transfer purchasing power from the present to the future.

**(b) How some direct instruments work as a tool of monetary policy?**

**Tools of Monetary Policy;**

These are the methods used by central banks to change the amount of money in circulation.

**Direct instruments**

The very common direct instruments are credit ceilings, interest rate controls and di- reacted landings. Following is an indication of how these direct instruments act as a tool of monetary policy.

* **Credit Ceiling (Ceilings On The Interest Rates)**

It is a kind of restriction imposed by the central bank above which interest rate can’t be increased. Credit ceilings are generally imposed because they control the inflation and balance of payments more quickly and precisely as compared to other conventional methods of monetary policy. It create excess demand for the credit.

* **Interest Rate Controls**

These are certain controls used for controlling the interest rates and its conditions. When the monetary sectors are not functioning well and cannot achieve their objectives so these interest rate controls limit the adverse effects of the circumstances by regulating the interest rates either by decreasing or increasing them according to monetary policy in order to gain stability.

* **Directed Lending**

This is an effective tool of monetary policy because this activity grant loans to typical borrowers on very reasonable interest rates (usually lower than other market interest rates) and due to this tool of monetary policy, a country can do much in developmental sectors like agriculture sector and housing constructions sectors etc.

**Q3: (a) What do you mean by “automatic stabilizers”? Give some examples. (4+4=8)**

**Automatic stabilizers**

Automatic stabilizers are the features of fiscal policy that automatically stabilize the economy. Automatic Stabilizers stimulate AD during periods of recession and dampen AD during periods of expansion.

**Examples of automatic stabilizers**

1. **Progressive Income Taxes**
2. **During Prosperous Time**

During this period, more people get paid, the more taxes they pay. Taxes prevent some of this increased income from entering the economy, which keeps inflation in check.

1. **During Recession**

During recession, people make less, taxes less, which reduces impact of recession.

1. **Public Transfer Payments** (such as unemployment insurance, welfare programs etc.)
2. **In A Recession**

More people qualify for government benefits like food stamps in a recession. They get more money to spend from the government this increases aggregate demand and helps the economy.

1. **During Inflationary Periods**

During this period, economy is doing well so less people qualify for benefits like food stamps. This takes currency out of the economy, which reduces aggregate demand, and keeps prices from rising.

**(b) How inflation is measured?**

The most appropriate and commonly used to measure inflation is the Consumer Price Index (CPI), which measures the percentage change in the price of a basket of goods and services consumed by households.

Simply, the Consumer Price Index (CPI) uses a "basket of goods" approach that aims to compare a consistent base of products from year to year, focusing on products that are bought and used by consumers regularly. The market basket is updated every few years to remove goods and services that might have become obsolete or irrelevant.

The percentage changes in CPI measures inflation (change is prices). The CPI measures price change from the perspective of the purchaser or buyer. The price changes (inflation) in consumer goods and services such as gasoline, food, clothing and automobiles are all measured in CPI. Even, the price of your milk, eggs, toothpaste and a haircut are all captured in the CPI.

**Q4: (a) Give some of the causes of cost push inflation? (4+3=7)**

**Cost Push Inflation**

It is situation that is caused by producers, where level of prices increase or rise due to increase in cost of production and this situation is called as cost push inflation.

**Causes of Cost Push Inflation**

The following are the main causes of Cost-Push inflation:

1. **Increase in Cost of Raw Materials:**

When the prices of raw materials increase this increase the cost of production of the producer and the producer increases the price of the product.

1. **Increase In Wages:**

The rise in wages increases the cost of production which increases the price of the product.

1. **Decrease In Production:**

Changes in the volume of production, has inverse effect on price level. If in some situation such as floods, war or political disturbances, production of goods falls, prices tend to rise.

1. **Imported Inflation:**

Sometimes a country has to face inflation because it imports goods from other countries at continuously rising prices.

1. **Indirect Taxes:**

Indirect taxes also push up prices of goods. When the government imposed the sales tax on the commodities like oil, gas, electricity, telephone, food products etc. the price goes up in the market.

**(b) Why inflation is good?**

**Reasons**

Inflation mostly comes out as beneficial and helpful at macroeconomics levels. Following are some of the reasons / points that will make it clear why and how inflation proves to be good.

* Inflations prove to be helpful in increasing the production in a situation when the economy is not running at its capacity (meaning in a situation when they are unused labor and resources).
* Inflation also makes it easier on debtors, who repay their loans with money that is less valuable than the money they borrowed. This encourages borrowing and lending, which again increases spending on all levels.
* Small amounts of inflation encourage consumption. For example, if you wanted to buy a specific item, and knew that the price of it would rise by 2-3% in a year, you would be encouraged to buy it now. Thus, inflation can encourage consumption which can in turn further stimulate the economy and create more jobs.
* Inflation promotes economic growth. With economic growth, we usually get a degree of inflation that helps in analyzing the position of a country.
* It helps in adjusting the real wages.
* Moderate inflation allows adjustment of prices.
* Moderate rates of inflation are an indication of a healthy economy because it results in increasing wages and corporate profitability letting capital flow in an expected growing economy.

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