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Q1. MCQ'S

1) State Bank.

2) Keyenesian Economist

3) Public Employment Project

4) Monetary policy

5) Increase Reserve Requirement

6) 3 Reasons

7) Creditors

8) Reserve ratio

9) Recession

10) Stagflation

Part B

Q1 Disinflation:

Disinflation is a temporary slowing of the pace of price inflation. Disinflation is used to describe instances when the inflation rate has reduced marginally over short term. A healthy amount of disinflation is necessary, since it represents economic contraction and prevents the economy from overheating. Disinflation is very common and is viewed as normal. Disinflation benefits certain segments of a population, such as people who are inclined to save their earnings.

Hyperinflation:

Hyperinflation is a situation where the price increases are too sharp. Hyperinflation often occurs when there is a large increase in the money supply, which is not supported by growth in GDP. Such situation results in an imbalance in the supply and demand for the money. This results in sharp increase in prices and depreciation in the domestic currency.

Central bank:

Central bank is the supreme financial institution that regulates the banking and monetary system of the country. Central bank is formed to bring monetary stability, issue currency notes and maintain the value of currency in international markets. Central bank is a banker to the government and other banks.

Commercial bank:

The establishment which provides banking service to the public is known as commercial bank. it is the banker to the citizen of the nation. it provides various banking services to general public like approve loans and savings accounts to individuals and small businesses.

Demand pull:

Demand pull inflation is the increase in aggregate demand, categorized by the four sections of the macroeconomy (Households, Business, Governments and foreign buyers. Demand pull inflation can be by an expanding economy, increased government spending, or overseas growth.

Cost Push Inflation:

Cost push inflation is the decrease in the aggregate supply of goods and services stemming from an increase in the cost of production. An increase in the costs of raw materials or labor can contribute to cost pull inflation.

Expansionary fiscal policy:

Expansionary fiscal policy is the increases the level of aggregate demand, either through increase in government spending’s or cut in taxes.

Contractionary fiscal policy:

Contractionary fiscal policy is the decreases the level of aggregate demand, either through cuts in government spending’s or increase in taxes.

Open Market Operation:

Open Market Operation is an activity by a central bank to give liquidity in its currency toa bank or group of banks. open Market Operations are flexible, and thus the most frequently used tool of monetary policy.

Discount Rate:

Discount rate is the minimum interest rate fixed by the federal reserve bank to depository institutions on short term loans.

Q4(a)

Definition

Cost push inflation is the decrease in the aggregate supply of goods and services stemming from an increase in the cost of production. An increase in the costs of raw materials or labor can contribute to cost pull inflation. Cost push Inflation occurs when we experience rising prices due to higher costs of production and higher costs of raw material. Cost push inflation is determined by supply side factors.

Causes of cost push inflation

Higher prices of commodities

A rise in the price of input goods used in manufacturing as raw material would see some rise in costs.

Imported inflation

A devaluation will increase the domestic price of imports. Therefore, after a devaluation we often get an increase in inflation due to rising costs of imports.

Higher Wages

Wages are one the main costs facing firms. Rising wages will push up the prices as firms have to pay higher costs.

Higher Taxes

Higher VAT and excise duties will increase the prices of goods. This price increase will be temporary increase.

Profit push inflation

If firms gain increased monopoly power, they are in a position to push up prices to make more profit.

Q4(b)

Inflation is good in a sense that Inflation makes it easier on debtors, who repay their loans that is less valuable than money they borrowed. this encourages borrowing and lending, which increases spending on all levels. Contrary to its negative effects, a moderate level of inflation characterizes a good economy. An inflation rate of 2 or 3 % is beneficial for an economy as it encourages people to buy more and borrow more, because during times of low inflation, the level of interest rate also remains low. inflation is good when it is mild. inflation makes consumers expect prices to continue rising. When prices are going up, people will buy now rather than pay more later. this increases demand in short term. As a result, stores sell more and factories produce more now. They are more likely to hire new workers to meet demand. It creates a virtuous cycle, boosting economic growth.

Q3(a)

Automatic Stabilizer’s

Automatic Stabilizer’s are a type of fiscal policy designed to offset fluctuations in a nation's economic activity through their normal operation without additional, timely authorization by the government or policy makers. The best knows automatic stabilizers are progressively graduated corporate and personal income taxes, and transfer systems such as unemployment insurance and welfare. Automatic stabilizer’s act to stabilize economic cycles and are automatically triggered without additional government action.

Example of Automatic Stabilizer’s

The best example of Automatic stabilizer’s are unemployment insurance payments, which increase during a recession as income falls. During Expansions unemployment insurance payment decrease s and income taxes increase.

Q3(b)

Measurement of inflation

Measuring changes in average price levels requires the use of a device called an index. It is impossible to keep an accurate record of price change. Inflation is obtained by calculating the change in percentage of current index over the previous one. the price index is developed by carrying out a survey on costs of a number of goods and services that comprise the economy.

Consumer Price Index (CPI)

CPI is an internationally comparable measure of inflation which means changes in price from the purchaser’s perspective. it is a measure of price changes in consumer goods and services such as food, clothing, gasoline and automobiles but excludes housing costs and mortgage interest payments. it reflects changes in prices of a market basket of services and goods purchased by consumers. CPI helps in the measurement of cost of living of urban consumers.

CPI is a statically estimate constructed with the help of prices of items that represent the economy, whose prices are collected periodically. the annual percentage change in CPI is taken as a measure of inflation.

Calculating CPI

Calculation of CPI and inflation requires data on prices of goods and services in large scale.

Determination of basket of goods and services.

Determination of prices.

Computation of cost of basket of goods in each year.

Selection of base year and computation of CPI.

Computation of inflation rate using CPI.

Q2(a)

Money

Functions of Money:

Medium of Exchange:

Money's most important function is as a medium of exchange to facilitate transactions. Without money all transactions would be conducted by barter, which involves direct exchange of goods or services. Money effectively eliminates the double coincidence of wants Problem by serving as a medium of exchange that is accepted in all transactions, by all parties, regardless of whether they desire each other's goods and services.

Store of value

In order to be a medium of exchange, Money must hold its value over time that is, it must be a store of value. if money could not be stored for some period of time and still remain valuable in exchange. it would not solve the double coincidence of wants problem and therefore would not be adapted as a medium of exchange. Money is more liquid than most others store value because as a medium of exchange, it is readily accepted everywhere. Furthermore, money is an easy transported store of value that is available in a number of convenient denominations. Money can be held over a period of time and used to finance future payments. Moreover, when people save money they get the assurance that the money saved will have value when they wish to spend it in the future.

Unit of Account

Money also functions as a unit of account, providing a common measure of the value of goods and services being exchanged. Knowing the value or price of a good, in terms enables both the supplier and the purchaser of the good to make decisions about how much to supply and how much to purchase. The implication is that money is used to measure and record financial transaction as also the value of goods and services produced inQ2 a country overtime.

Q2(b)

Monetary policy

Monetary policy refers to the actions undertaken by a nation's central bank to control money supply to achieve goals that promote sustainable economic growth.

First instrument is open market operation. Open market operations tradionally target short term interest rates such as the federal funds rate. the central bank adds money into the banking system by buying assets, and banks respond by loaning the money more easily at lower rates, until the central bank's interest rate target is met. Open market operations can also target specific increases in the money supply in order to get the bank to loan funds more easily, by purchasing a specified quantity of assets in a process known as quantitative asing.

Second instrument is reserve requirement. Reserve requirements are the portions of deposits that bank must hold in cash, either in their vaults or on deposit at a reserve bank. A decrease in reserve requirements is expansionary because it increases the funds available in the banking system to lend to consumers and businesses. An increase in reserve requirements is contractionary because it reduces the funds available in the banking system to lend to consumers and businesses. The board of governors has sole authority over change to reserve requirements.