School of Management and Social Sciences (Dept. of Business Administration)

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Course Code: ECO 244 **Course Title: Macroeconomics**

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Total Marks: 50

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DEPARTMENT: BBA

SECTION: A

Instructor: Ms. Wajiha Amin

Part A (Total marks 10)

- (1) Printing of money is an important function of

(a) State bank (b) Currency markets (c) Commercial banks

- (2) Fiscal policy is based upon the ideology of

(a) Classical economists (b) Keyensian economist (c) Modern economist

- (3) National Internship programe (NIP) is an example of

(a) Public work (b) Public employment project (c) Automatic stabilizer

- (4) Government budget is an example of

(a) Monetary policy (b) Foreign policy (c) Fiscal policy

- (5) To control inflation, Central Banks:

(a) Increases reserve requirement (b) Decrease discount rate (c) Sell T-Bills

- (6) People demand money for

(a) 2 reasons (b) 3 reasons (c) 4 reasons

- (7) High inflation greatly benefited the

(a) Creditors (b) exporters (c) Fixed assets owners

- (8) The amount which each bank must keep with the central bank is

(a) Reserve ratio (b) Discount rate (c) Ceiling rate

- (9) Expansionary fiscal policy is used during

(a) Inflation (b) Recession (c) Depression

- (10) Unchecked increase in money supply results in

(a) Deflation (b) Stagflation (c) Hyperinflation

PART B

Q1: Differentiate between: (5x3=15)

- Disinflation and hyperinflation

Disinflation is a temporary slowing of the pace of price inflation. It is used to describe instances when the inflation rate has reduced marginally over the short term.
It occurs when the rate at which the prices are raising is diminishing.
It signals a slow in the growth rate of inflation.

In economics, hyperinflation is used to describe situations where the prices of goods and services rise uncontrollably over a defined time period
During hyperinflationary periods, the prices level increases by about 500% to 1000% per year and prices are out of control.

A significant rise in money supply not supported by economic growth.

- Central bank and commercial bank

Central Bank:

1. Work for the public welfare and economic development of a country. A central bank is governed by the government of a country.

2. Controls and regulates the entries banking system of a country.

3. Does not deal directly with the public. It issues guidelines to commercial banks for the economic development of the country.

4. Issues currency and control the supply of money in the Market.

5. Acts as a state owned institution.

6. Act as a custodian of a foreign exchange of the country.

7. Act as a banker to the Government.

8. Controls credit creations in the economy, thus acts as a clearing house of other banks.

Commercial Bank:

1. Operates for Profit Motive. The Majority of Stake is held by the government as well as the private sector.

2. Operates under the direct control and supervision of the central bank. In India all the commercial banks work under the guidelines issued by RBI.

3. Deals directly with the Public. It serves the financial requirement of the public by providing short and medium terms loans and depositing and securing money that can be drawn on demand.

4. Does not Issue currency, but only adds to the approval of the central bank.

5. Acts as a state or private owned institution.

6. Perform foreign exchange business only on the approval of the central bank.

7. Acts as agents of the central bank.

8. Acts as a clearing house only as a agent of the central bank.

Demand pull and cost push inflation

1. Demand-pull inflation arises when the aggregate demand increases at a faster rate than aggregate supply. Cost-Push Inflation is a result of an increase in the price of inputs due to the shortage of cost of production, leading to decrease in the supply of outputs.
2. Demand-pull inflation describes, how price inflation begins
3. On the other hand, cost-push inflation explains Why inflation is so difficult to stop, once started?
4. The reason for demand-pull inflation is the increase in money supply, government spending and foreign exchange rates. Conversely, cost-push inflation is mainly caused by the monopolistic groups of the society.

Expansionary and contractionary fiscal policy

Expansionary fiscal policy:

Expansionary fiscal policy increases the level of aggregate demand, through either increases in government spending or reductions in taxes. Expansionary policy can do this by:

- Increasing consumption by raising disposable income through cuts in personal income taxes
- . Increasing investments by raising after-tax profits through cuts in business taxes.
- Increasing government purchases through increased spending by the federal government on final goods and services.
- Used in the recession period when the economy slows down.
- Expands the amount of currency in the economy.

Contractionary fiscal policy:

- It decreases the level of aggregate demand by decreasing consumption, decreasing investments.
- Decreasing government spending, either through cuts in government spending or increases in taxes
- . Used during inflation period.
- Reduces the amount of currency in the economy.

- ## Open market operation and discount rate.

Open market operations

The Federal Reserve buys and sells government securities to control the money supply and interest rates. This activity is called Open Market operations. To increase the money supply, the Fed will purchase bonds from banks, which injects money into the banking system.
Central bank sell and purchase the securities to the public, govt., businesses etc. When they buy government bonds, the money supply increases When they sell government bonds, the money supply decreases

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 while decreasing the discount rate increases the money supply.

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

Money

is something that people use every day. We earn it and spend it but don't often think much about it. Economists define money as any good that is widely accepted as final payment for goods and services

1. **Medium of exchange:** Money allows goods and services to be traded without the need for a barter system. Barter systems rely on there being a double coincidence of wants between the two people involved in an exchange.

2. Store of value: This can refer to any asset whose “value” can be used now or used in the future i.e. its value can be retrieved at a later date. This means that people can save now to fund spending at a later date.

3. Unit of account: This refers to anything that allows the value of something to be expressed in an understandable way, and in a way that allows the value of items to be compared.

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

1. Ceilings on interest rates:

A level or restriction imposed by the central bank above which rate can’t be increased.

1 Create excess demand for credit.
2 Prone to abuse.
3 Inefficient and unfair.

2. Quotas on credit

1 A maximum or minimum limit on quantity. Applied to imports, a quota designates the maximum quantity of a product that may be brought into a country during a specified period of time. Quotas can have significant impact on certain industries and companies. The establishment of a quota or a change in an existing quota can influence the price of the affected firm's securities

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

Automatic Stabilisers

Automatic stabilizers refer to how fiscal instruments will influence the rate of growth and help counter swings in the economic cycle. Automatic stabilizers will influence the size of government borrowing.

Example of automatic stabilisers

- **High Growth** – In a period of high economic growth, automatic stabilisers will help to reduce the growth rate. With higher growth, the government will receive more tax revenues – people earn more and so pay more income tax (note the tax rate doesn't change, the amount received just becomes higher). With higher growth, there will also be a fall in unemployment so the government will spend less on unemployment benefits.
  - In a period of high growth – ceteris paribus government borrowing will fall.
- **Recession**. In a recession, economic growth becomes negative. However, automatic stabilisers will help to limit the fall in growth. With lower incomes, people pay less tax, and government spending on unemployment benefits will increase. This increase in benefit spending and lower tax collection helps to limit the fall in aggregate demand.
  - In a recession – ceteris paribus government borrowing will increase

(b) How inflation is measured?

inflation is a measurement of the rise in the average price of all goods and services in the economy, somebody has to actually go out and collect all of that data.

One of the most commonly used measure for inflation

1 A measure of price changes in consumer goods and services such as gasoline, food, clothing and automobiles. The CPI measures price change from the perspective of the purchaser.

2 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 on a daily basis. The price of your milk, eggs, toothpaste and a haircut are all captured in the CPI.

3 The market basket is updated every few years to remove goods and services that might have become obsolete or irrelevant.

4 Percentage changes in CPI measures inflation.

Change in Inflation = (Final CPI Index Value/Initial CPI Value

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

1. **Supply Shock**

A supply shock is when there is a big increase in prices of critical commodities like oil. This results in higher transport costs and all firms would see a rise in costs.

2. **Higher Wages**

Wages form a large percentage of costs for firms. Strong labor unions can influence inflation as they push for higher wages, which will lead to an increase in costs of production for the firm and hence higher priced goods.

3**. Imported inflation**

Economies operate within a global context and many firms import a significant proportion of their raw materials. If the cost of these increase for reasons beyond their control, then firms may increase prices to pay these higher raw material costs, although this will depend upon elasticities of demand

4**. Higher Taxes**

An increase in indirect taxation. Higher VAT and Excise duties will increase the prices of goods.

Profits

If firms gain more power and are able to push up prices independently of demand to make more profit, then this is considered to be cost-push inflation. This is most likely when markets become more concentrated and move towards a monopoly or perhaps an oligopoly position.

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 fall, price tends to rise.

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 prices goes up in the market

- ## (b) Why inflation is good?

Economists generally argue that some inflation is a good thing. A healthy rate of inflation is considered to be approximately 2-3% per year. The goal is for inflation (which is measured by the Consumer Price Index, or CPI) to outpace the growth of the underlying economy (measured by Gross Domestic Product, or GDP) by a small amount per year.

1 A healthy rate of inflation is considered a positive because it results in increasing wages and corporate profitability and keeps capital flowing in a presumably growing economy.

2 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.

3 However, as some inflation may be good on macroeconomic level, on microeconomic level it might be quite bad for someone (individuals my not like higher prices)

OR

(b) Briefly compare monetary policy and fiscal policy used in the development of economy.