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

Final term spring semester 2020

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

Instructor: Ms. Wajiha Amin

Total Marks: 50

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
- Central bank and commercial bank
- Demand pull and cost push inflation
- Expansionary and contractionary fiscal policy
- Open market operation and discount rate.

Q2: (a) Briefly define money and discuss few of its functions. **(5+5)**
(b) How some direct instruments work as a tool of monetary policy?

Q3 : (a) What do you mean by ***"automatic stabilizers"?*** Give some examples. **(4+4=8)**
(b) How inflation is measured?

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

OR

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

NAME: Muhammad Ali Sohail
ID: 15989
Semester: 2nd (sec-A)
Instructor's Name: Miss Wajiha Amin
Subject: Macroeconomics
Date: 27 June 2020

PART (A)

1. (a) State bank
2. (b) Keynesian
3. (b) Public employment project
4. (c) Fiscal policy
5. (a) Increases reserve requirement
6. (b) 3 reasons
7. (b) Exporters
8. (a) Reserve ratio
9. (b) Recession
10. (c) Hyperinflation

PART (B)

Q1: Differentiate between : (5x3=15)

- **Disinflation and hyperinflation**
- **Central bank and commercial bank**
- **Demand pull and cost push inflation**
- **Expansionary and contractionary fiscal policy**
- **Open market operation and discount rate.**

• Disinflation and hyperinflation

Disinflation:

Disinflation is the opposite of inflation. Disinflation refers to situation, where there is decline in general price levels. Thus, deflation occurs when the inflation rate falls below 0% (or it is negative inflation rate). It increases the real value of money and allows one to buy more goods with the same amount of money over time. Disinflation can occur owing to reduction in the supply of money or credit. It can also occur due to direct contractions in spending, either in the form of a reduction in government spending, personal spending or investment spending. Disinflation has often had the side effect of increasing unemployment in an economy, since the process often leads to a lower level of demand in the economy.

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 Gross Domestic Product (GDP). Such a situation results in an imbalance in the supply and demand for the money. In this remains unchecked; it results into sharp increase in prices and depreciation of the domestic currency.

- ## Central bank and commercial bank

Central Bank	Commercial Bank
Works for the public welfare and economic development of a country. A central Bank is governed by the government of a country.	Operates for profit motive. The majority of stake is held by the government as well as the private sector.
Does not deal directly with the public. It issues guidelines to commercial banks for the economic development of a country.	Deals directly with the public. It serves the financial requirements of general public by providing short and medium-term loans and depositing and securing money that can be drawn on demand.
Issues currency and controls the supply of money in the market.	Does not issue currency, but only adds to the money supply by creating demand deposits.
Acts as a state owned institution.	Acts as a state or private owned institution.
Acts as a custodian of foreign exchange of the country.	Performs foreign exchange business only on the approval of the central bank.
Acts as a banker to the government.	Acts as agents of the central bank.
Controls credit creation in economy. Thus, acts as a clearing house of other banks.	Acts as clearing house only as an agent of the country.

- **Demand pull and cost push inflation**

Demand pull inflation	Cost push inflation
The price level rises because of excess demand condition in the market.	The price level rises because of increasing costs of production.
Rise in population, rise in income etc. are the demand-pull factors.	Rise in the prices of factors of production such as fuel price, wage cost etc. are the cost-push factors.

- **Expansionary and contractionary fiscal policy**

Expansionary Fiscal Policy	Contractionary Fiscal Policy
Expansionary fiscal policy is used to increase economic growth.	Contractionary fiscal policy is used to decrease economic growth.
This is when government cut taxes or increase spending.	This is when governments increase taxes or decrease spending.
Increase in income transfers.	Decrease is income transfers.
Reduces employment.	Increase employment.
Can lead to inflation.	Reduces inflation.

- **Open market operation and discount rate.**

Open Market Operation:

Open market operations (OMO) refers to when the Federal Reserve purchases and sells Treasury securities on the open market in order to regulate the supply of money that is on reserve in banks, and therefore available to loan out to businesses and consumers. It purchases Treasury securities to increase the supply of money and sells them to reduce the supply of money.

Discount rate:

Discount rate is the interest rate on loans that the Federal Reserve makes to banks. Banks occasionally borrow from the Federal Reserve when they find themselves short on reserves. A lower discount rate increases banks' incentives to borrow reserves from the Federal Reserve, thereby increasing the quantity of reserves in the banking system and causing the money supply to rise.

Question: 2 (a)

(a) Briefly define money and discuss few of its functions

ANSWER

Definition of Money

Money, in simple terms, is a medium of exchange. It is instrumental in the exchange of goods and/or services.

Further, money is the most liquid assets among all our assets. It also has general acceptability as a means of payment along with its liquid nature.

Usually, the Central Bank or Government of a country creates and issues money. Also called cash money, this is a legal tender and hence there is a legal compulsion on citizens to accept it.

Functions of Money

There are many static and dynamic functions of money as follows:

Static Functions of Money

These functions are:

- ***A medium of Exchange*** – In an exchange economy, money plays an intermediary role. It makes the exchange system smooth and convenient.
- ***A measure of Value*** – The value of a product or service is determined on the basis of the money needed for its possession. This helps in making the exchange a mutually profitable activity.
- ***The Standard of Deferred Payments*** – Money plays an important role in lending and borrowing. Money is taken as a loan and repaid after a time-gap.

- ***Store of Value*** – You can store the purchasing power of money and keep a part of it for future use – monetary savings. You can use your current income for current consumption as well as future consumption through savings.

Dynamic Functions of Money:

These functions are:

- Money can activate idle resources and put them into productive channels.
- Therefore, it helps in increasing output, employment, and also income levels.
- Further, it helps in converting savings into investments.
- The creation of new money governments of modern economies can spend more than what they earn.

Question: 2 (b)

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

ANSWER

Direct instruments set or limit either prices (interest rates) or quantities (credit) through regulations, while indirect instruments operate through the market by influencing underlying demand and supply conditions;

Direct instruments in the form of credit ceilings are mainly aimed at the balance sheets of the commercial banks, while most indirect instruments are aimed at the balance sheet of the central bank.

Question: 3(a)

(a) What do you mean by *"automatic stabilizers"?* Give some examples.

ANSWER

Automatic stabilizers are a type of fiscal policy that happen automatically and tend to offset fluctuations in economic activity without direct intervention from policymakers. They are tax structures and government spending programs that lead to larger budget deficits during recessions and larger surpluses during expansions. Sometimes called 'non-discretionary,' they are 'automatic,' meaning that no spending law has to be passed in order for them to take place. In addition, they help stabilize a contracting economy; therefore, they're referred to as economic 'stabilizers.'

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.

Question: 3(b)

(b) How inflation is measured?

ANSWER

- The rate of inflation is measured by the annual percentage change in consumer prices.

- Some country's government has set an inflation target of (for example) 2% using the consumer price index (CPI)

- It is the job of the Bank of the country to set interest rates so that aggregate demand is controlled, inflationary pressures are subdued and the inflation target is reached.

- The Bank is independent of the government with control of interest rates and it is free from political intervention. The Bank is also concerned to avoid price deflation.

Question: 4(a)

(a) Give some of the causes of *cost push inflation?*

ANSWER

CAUSES OF COST PUSH INFLATION:

1) RISING INPUT COSTS:

Rise in the price of oil, raw materials or components.

2) RISING LABOR COSTS:

Shortage of skilled IT workers enabling them to ask for high pay rises.

3) HIGHER IMPORT PRICES:

High inflation in other countries means the goods you import become more expensive (you import inflation).

4) INCREASES IN INDIRECT TAXES:

Increases in National Insurance or an energy tax will increase the costs of producers.

(b) Why inflation is good?

ANSWER

Inflation is good because:

- It enables economic growth.
- It allows adjustment of real wages.
- It also allows adjustment of prices.
- Inflation is better than deflation which can cause recession.