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**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 Disinflation and hyperinflation**

 **: (5x3=15)**

**Disinflation:**

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.

Disinflation refers to the rate of change in the rate of inflation.

A Certain amount of disinflation is necessary, since it represents economic contraction and prevents the economy from overheating.

Disinflation benefits certain segments of a population, such as people who are inclined to save their earnings.

Several main reasons can cause an economy to experience disinflation. If a central bank decides to impose a tighter monetary policy and the government starts to sell off some of its securities, it could reduce the supply of money in the economy, causing a disinflationary effect

A contraction in the business cycle or a recession can also cause disinflation. For example, businesses may choose not to increase prices to gain greater market share, leading to disinflation.

**Hyperinflation:**

* Hyperinflation is a term to describe rapid, excessive, and out of control general price increases in an economy.
* hyperinflation is rapidly rising inflation, typically measuring more than 50% per month.
* Hyperinflation is a rare event for developed economies, it has occurred many times throughout history in countries such as China, Germany, Russia, Hungary, and Argentina.
* Hyperinflation can occur in times of war and economic turmoil in the underlying production economy in conjunction with a central bank printing an excessive amount of money.
* Hyperinflation can cause a surge in prices for basic goods such as food and fuel as they become scarce.
* While hyperinflation are typically rare, once they begin they can spiral out of control.
* **Central bank and commercial bank**
* A central bank is a financial institution that is responsible for overseeing the monetary system and policy of a nation or group of nations, regulating its money supply, and setting interest rates.
* Central banks enact monetary policy, by easing or tightening the money supply and availability of credit, central banks seek to keep a nation's economy on an even keel.
* A central bank sets requirements for the banking industry, such as the amount of cash reserves banks must maintain their deposits.
* A central bank can be a lender of last resort to troubled financial institutions .

**Commercial Banks**

* There is no difference between the type of money creation that results from the commercial money multiplier or a central bank, such as the Federal Reserve.
* Commercial banks make money by providing loans and earning interest income from those loans.
* A growing number of commercial banks operate exclusively online, where all transactions with the commercial bank must be made electronically.
* **Demand pull and cost push inflation**

**Demand Pull inflation:**

* When demand surpasses supply, higher prices are the result. This is demand pull inflation.
* A low unemployment rate is unquestionably good in general, but it can cause inflation because more people have more disposable income.
* Increased government spending is good for the economy, too, but it can lead to scarcity in some goods and inflation will alllow

**Cost Push Inflation:**

* Cost push inflation occurs when overall prices increase (inflation) due to increases in the cost of wages and raw materials.
* Cost push inflation can occur when higher costs of production decrease the aggregate supply (the amount of total production) in the economy.
* Since the demand for goods hasn't changed, the price increases from production are passed onto consumers creating cost push

Inflation .

* **Expansionary and contractionary fiscal policy**

**Expansionary Fiscal Policy :**

* Expansionary policy seeks to stimulate an economy by boosting demand through monetary and fiscal stimulus.
* Expansionary policy is intended to prevent or moderate economic downturns and recessions.
* Though popular, expansionary policy can involve significant costs and risks including macroeconomic, microeconomic, and political economy issues.

**Contractionary Fiscal Policy :**

* Contractionary policies are macroeconomic tools designed to combat economic distortions caused by an overheating economy.
* Contractionary policies aim to reduce the rates of monetary expansion by central banks.
* Contractionary policies are typically issued during times of extreme inflation.
* **Open market operation and discount rate.**

**Open Market Operation:**

* Open market operations refers to a central bank buying or selling short term Treasuries in the open market in order to influence the money supply, thus influencing short term interest rates.
* Buying securities adds money to the system, making loans easier to obtain and interest rates decline.
* Selling securities from the central bank's balance sheet removes money from the system, making loans more expensive and increasing rates.
* These open market operations are the method the Fed uses to manipulate interest rates.

 **Discount Rate :**

* The term discount rate can refer to either the interest rate that the Federal Reserve charges banks for short term loans or the rate used to discount future cash flows in discounted cash flow (DCF) analysis.
* In a banking context, the discount lending is a key tool of monetary policy and part of the Fed's function as lender of last resort.
* In DCF, the discount rate expresses the time value of money and can make the difference between whether an investment project is financially viable or not.

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

Money is an economic unit that functions as a generally recognized medium of exchange for transactional purposes in an economy. Money provides the service of reducing transaction cost, namely the double coincidence of wants. Money originates in the form of a commodity, having a physical property to be adopted by market participants as a medium of exchange.

**Functions of Money**

As stated above, money primarily functions as a medium of exchange. However, it also has developed secondary functions that derive from its use as a medium of exchange. These other functions include:

1) a unit of account,

2) a store of value

 3) a standard of deferred payment.

Unit of Account

Due to its use as a medium of exchange for both buying and selling and its use to assign prices to all kinds of other goods and services, money can be used to keep track of the money gained or lost across multiple transactions and to compare money values of various combinations of different quantities of different goods and services mathematically. This makes things such as accounting for profit and loss of a business, balancing a budget, or valuing the total assets of a company all possible.

**Store of Value**

Because money's usefulness as a medium of exchange in transactions is inherently future oriented, it provides a means to store value obtained through current production or trade for use in the future, in the form of other goods and services. In particular trading their non fungible, non durable, non portable, non recognizable, or non stable goods or services for money here and now, people can store the value of those goods to trade for goods at other times and places. This facilitates saving for the future and engaging in transactions over long distances possible.

**Standard of Deferred Payment**

To the extent that money is accepted as a general medium of exchange and serves as useful store of value, it can be used to transfer value for exchange use at different times between people through the tools of credit and debt. One person can loan a quantity of money to another for a period of time to use and repay another agreed upon quantity of money at a future date. The stored value represented by the loaned money is transferred from the lender to the borrower in exchange for an agreed quantity of stored value in the future. The borrower can then use and enjoy the value of other goods and services that they can now purchase in exchange for payment at a later date. The lender in effect is able to loan the current use of real goods and services, which he does not himself originally possess, to the borrower. The sellers of the goods are able to receive payment for their goods now instead of loaning the goods directly to the borrower in hope of future return or repayment.

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

Central banks have three main monetary policy tools: open market operations, the discount rate, and the reserve requirement. Most central banks also have a lot more tools at their disposal. Here are the three primary tools and how they work together to sustain healthy economic growth.

**1 :Open Market Operations**

Open market operations are when central banks buy or sell securities. These are bought from or sold to the country's private banks. When the central bank buys securities, it adds cash to the banks' reserves. That gives them more money to lend. When the central bank sells the securities, it places them on the banks' balance sheets and reduces its cash holdings. The bank now has less to lend. A central bank buys securities when it wants expansionary monetary policy. It sells them when it executes contractionary monetary policy.

**2. Reserve Requirement**

The reserve requirement refers to the money banks must keep on hand overnight. They can either keep the reserve in their vaults or at the central bank. A low reserve requirement allows banks to lend more of their deposits. It's expansionary because it creates credit. A high reserve requirement is contractionary. It gives banks less money to lend. It's especially hard for small banks since they don't have as much to lend in the first place. That's why most central banks don't impose a reserve requirement on small banks. Central banks rarely change the reserve requirement because it's difficult for member banks to modify their procedures.

**3. Discount Rate**

The discount rate is the third tool. It's the rate that central banks charge its members to borrow at its discount window.Since it's higher than the fed funds rate, banks only use this if they can't borrow funds from other banks.

Using the discount window also has a stigma attached. The financial community assumes that any bank that uses the discount window is in trouble. Only a desperate bank that's been rejected by others would use the discount window.

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

* Automatic stabilizers are ongoing government policies that automatically adjust tax rates and transfer payments in a manner that is intended to stabilize incomes, consumption, and business spending over the business cycle.
* Automatic stabilizers are a type of fiscal policy, which is favored by Keynesian economics as a tool to combat economic slumps and recessions.
* In the event of acute or lasting economic downturns, governments often back up automatic stabilizers with one time or temporary stimulus policies to try to jump start the economy.
* When an economy is in a recession, automatic stabilizers may by design result in higher budget deficits. This is an aspect of fiscal policy, a tool of Keynesian economics use government spending and taxes to support aggregate demand in the economy through economic downturns. By taking less money out of private businesses and households in taxes and giving them more in the form of payments and tax refunds, fiscal policy is supposed to encourage them to increase, or at least not decrease, their consumption and investment spending in order to help prevent an economic set back from deepening.

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

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

 Inflation is a key measurement of where the economy might be headed, how consumers are doing day to day and it’s what the Federal Reserve chair, Jay Powell and his counterparts spend so much time trying to keep stable. So what are we talking about when we mention inflation? Here are four ways to measure it:

**1. The Consumer Price Index (CPI)**

Inflation is an increase in the price of goods or services. That market basket of goods and services includes a wide range of items such as food, televisions, prescription drugs, rent, gasoline and college tuition.

When people use the CPI, what they’re often using is the change in that index, which could be defined as inflation.

**Personal Consumption Expenditures (PCE)**

PCE is sometimes referred to as “consumer spending.” It’s calculated by the Bureau of Economic Analysis, the same organization that calculates Gross Domestic Product, or GDP.

The PCE actually uses some information from the CPI as inputs.

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

**Higher Price of Commodities**

 A rise in the price of oil would lead to higher petrol prices and higher transport costs. All firms would see some rise in costs. As the most important commodity, higher oil prices often lead to cost push inflation.

**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 cost of imports.

**Higher Wages**

Wages are one of the main costs facing firms. Rising wages will push up prices as firms have to pay higher costs (higher wages may also cause rising demand)

**Higher Taxes**

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

**Profit push inflation**

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

**Higher Food Prices**

In western economies, food is a smaller % of overall spending, but in developing countries, it plays a bigger role. (food inflation)

Cost push inflation could be caused by a rise in oil prices or other raw materials. Imported inflation could occur after a depreciation in the exchange rate which increases the price of imported goods.

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

Inflation is good when it is mild. There are two situations where this occurs. The first is when 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 the 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.

The second is when it removes the risk of deflation. That’s when prices fall. When that happens, people wait to see if prices will drop more before buying. It cuts back demand, and businesses reduce their inventory. As a result, factories produce less and lay off workers. Unemployment rises, leading to wage deflation. Workers have less money to spend, which reduces demand even more. Businesses lower their prices. That makes deflation worse. For this reason, deflation is even more corrosive to economic growth than inflation. Prices fell 10% during the worldwide Great Depression.

 **OR**

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