

ISC SEMESTER 2 EXAMINATION
SPECIMEN QUESTION PAPER
ECONOMICS

Maximum Marks: 40

Time allowed: One and a half hour

Candidates are allowed an additional 10 minutes for only reading the paper.

*They must **NOT** start writing during this time.*

*Answer **all** questions in Section A, Section B and Section C.*

The intended marks for questions or parts of questions are given in brackets. []

SECTION A – 8 MARKS

Question 1

- (i) Firm A sells flour to firm B for ₹ 100/- Firm B sells biscuits to the wholesaler C for ₹ 160/- and Firm C sells biscuits to consumers for ₹ 200/. Hence, the gross value added is: [1]
- (a) ₹ 460/-
 - (b) ₹ 305/-
 - (c) ₹ 244/-
 - (d) ₹ 200/-
- (ii) Medium of exchange and measure of value are: [1]
- (a) Primary functions of money
 - (b) Secondary functions of money
 - (c) Tertiary functions of money
 - (d) Contingent functions of money

- (iii) Aggregate supply is equal to: [1]
- (a) $C + I$
 - (b) $C + S$
 - (c) $I + C$
 - (d) $S_1 + S_2$
- (iv) Transfer earning in National income refers to: [1]
- (a) transfer of income from one person to another.
 - (b) income received by selling goods.
 - (c) unilateral payment received not related to any production.
 - (d) earning received by offering services.
- (v) A consumer spending on purchase of goods regardless of the income in possession, is an example of _____ consumption. [1]
- (vi) _____ is the creation of new currency to fill the gap between Government revenue and Government expenditure of the country. [1]
- (vii) $GNP(fc) = GNP(mp) - \underline{\hspace{2cm}}$ [1]
- (viii) Give one difference between a *Direct tax* and an *Indirect tax*. [1]

SECTION B – 12 MARKS

Answer the following questions briefly.

Question 2 [2]

Differentiate between CRR and SLR.

Question 3 [2]

Briefly explain two reasons for the adverse Balance of Payments in any economy.

Question 4 [2]

Draw a well labelled diagram of two sector model of circular flow of income including the financial sector.

Question 5 [2]

Complete the following schedule –

Y	C	APC	MPC
100	90	?	?
120	108	?	?

Question 6 [2]

(i) Differentiate between *Cash Credit* and *Outright Loans*.

OR

(ii) How is *Devaluation of currency* different from *Depreciation of currency*? Give any two differences.

Question 7 [2]

What is meant by the following functions of the Central bank:

(i) *Clearing house*

(ii) *Lender of the last resort*

SECTION C – 20 MARKS

Question 8 [4]

(i) What is meant by *Equilibrium income*? How is it determined by using Saving and Investment approach?

OR

(ii) Discuss the mechanism of investment multiplier with the help of a numerical.

Question 9 [4]

How is the rate of exchange determined in a flexible exchange rate system?

Question 10 [4]

Explain the steps involved in calculating the National income by Income method.

Question 11**[4]**

Explain the following methods of redemption of Public Debt:

- (i) *Debt conversion*
- (ii) *Sinking fund*

Question 12

Read the given extract carefully and answer the following questions.

Mr. X wanted to buy an expensive motorcycle for his son but he did not have sufficient money to buy it. He approached a public sector commercial bank for the loan. The bank asked Mr. X to deposit 20% cash of the loan amount and rest 80% of the loan amount was given by the bank.

- (i) Briefly explain a *Commercial Bank*. **[1]**
- (ii) What is the regulation of consumer credit in selective credit control? **[2]**
- (iii) Name the bank which controls all the commercial banks and financial institutions in the country. **[1]**

Section-B

Answer 2.

S.No.	CRR	SLR
1.	It refers to the percentage of net demand and time liabilities received by the commercial banks which is to be kept with RBI in the form of cash.	It is the percentage of net demand and time liabilities with the commercial banks which is to be kept with itself in the form of liquid assets <i>i.e.</i> , cash, gold.
2.	It is used to drain excess money out of the economic system.	It is used to ensure solvency of the commercial banks.

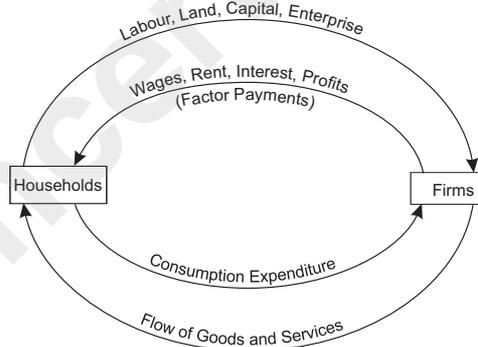
Answer 3.

Two reasons for the adverse Balance of Payments in any economy are:

- Cyclic fluctuations:** Cyclic fluctuation in the business activity leads to BOP disequilibrium. When there is a depression in a country, volume of both export and imports falls. But the fall in exports may be greater than fall in imports, due to the decline in domestic production. Therefore there is adverse BOP situation or disequilibrium.
- Price changes:** If there is inflation in the country, prices of the exports increases. As a result, the export falls. At the same time, the demand for the imports increases. This results in adverse balance of payment.

Answer 4.

Two sector model of circular flow of income includes firms and households. Following diagram shows the circular flow of income in two sector model with financial sector. Financial institutions such as banks, mutual funds, insurance companies etc. are collectively called financial sector.



In the upper part, the resources such as land, capital etc. flow from households to business firms and in opposite direction to this, money flows from firms to households in the form of factor payments.

In the lower part, money flows from households to firms as consumption expenditure made by the households on the goods and services produced by the firms, while the flow of goods and services is in opposite direction from business firms to households.

Answer 5.

Y	C	APC	MPC
100	90	0.9	Nd
120	108	0.9	0.9

Answer 6.

- Cash credit is a short term loan approved by the banks for businesses, 'financial institutions and companies to meet their working capital requirements. Outright loan is a lumpsum of money that a borrower intend to use for sure.

OR

(ii)

S.No.	Devaluation of currency	Depreciation of currency
1.	When the value of domestic currency falls in terms of foreign currency due to the decision of the central government, it is termed as devaluation of currency. It takes place under Fixed exchange rate system.	When the value of domestic currency falls in terms of foreign currency due to the market forces of demand and supply, it is termed as depreciation of currency. It takes place under Flexible exchange rate system.
2.	There is need to maintain a large reserve of foreign currency in order to devalue the currency.	There is no need to maintain large reserve of foreign currency in such situation.

Answer 7.

- (i) **Clearing house agent:** Central Bank acts as a clearing house agent for the bankers. Central Bank can easily settle the claims of various banks against each other simply by book entries of transfer from and to the accounts. This method of settling the account is called clearing house function of Central Bank.
- (ii) **As a lender to the last resort:** In case the commercial bank, fails to meet their financial requirement from other sources they can approach to the Central Bank as a last resort for loans and advances. Central Bank helps these banks by discounting approved securities and bills of exchange or providing loans against their securities. By providing temporary financial help, Central Bank saves the financial structure of the country from collapse. The direct lending to the commercial bank is referred to as lender to the last resort function of Central Bank.

Section-C

Answer 8.

- (i) Equilibrium level of income is determined, where aggregate demand is equal to aggregate supply in the economy. Graphically, it is a point where AD curve and AS curve intersects each other.

There are two approaches to attain the equilibrium level of income:

1. AD – AS approach
2. Saving and investment approach.

Saving and investment approach to attain the equilibrium level of income in the economy is explained below:

An economy attains equilibrium level of income only when planned savings are equal to the planned investment. Investment is assumed to be autonomous. It can be understood with the help of following:

- (a) **When planned savings are less than planned investment:** At the income level below the equilibrium level of income, the planned savings is less than planned investment. This means that households are consuming more than what the firms are expecting. The firms will witness shortfall in their inventory stock. This is termed as unplanned investment. To reach the desired level of inventory, firms will increase the production, leading to increase in output, income and employment.
- (b) **When planned savings are more than planned investment:** At the income level above the equilibrium level of income, the planned savings is more than the planned investment. This means that households are consuming less than what the firms are expecting. The firms will witness a rise in their inventory stocks. Thus there is an additional investment or unplanned investment. To have a desired level of inventory, firms will stop the production, leading to low output, income and employment.

OR

(ii) Mechanism of investment multiplier:

Investment multiplier is the number of times income rises due to a rise in the investment expenditure in the economy. It is represented as (K).

The working of multiplier is based on the assumption that one man's expenditure is another man's income.

Suppose, Government of the country, spends ₹100 crore on the construction of road i.e. $\Delta I = ₹100$. The first impact is that it increases the income of the workers engaged in the work by ₹100 crore.

Assuming $MPC = 0.75$, the workers will spend 75 crore i.e. 0.75×100 on consumer goods. The producers of these goods will have an additional income of 75 crore. This additional income will be spend on goods i.e. $0.75 \times 75 = ₹56.25$ crore:

This process will continue, till the change in income becomes equal to multiple times change in investment.

Hence,

Rounds	AI	AY	AC
I	100	100	75
II		75	56.25
III		56.25	42.18
		⋮	⋮
Total		400	300

$$K = \frac{1}{1 - MPC} = \frac{1}{1 - 0.75} = 4$$

$$K = \frac{\Delta Y}{\Delta I}$$

$$4 = \frac{\Delta Y}{100}$$

$$\Delta Y = ₹ 400$$

$$\text{Additional income} = ₹400$$

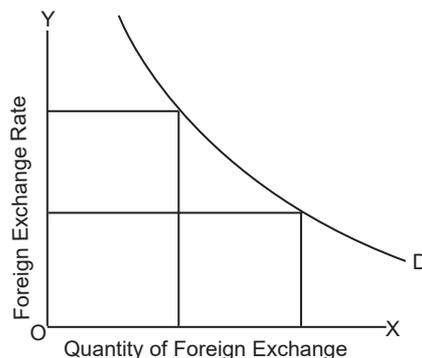
Answer 9.

Under Flexible exchange rate system, the rate of exchange is determined by the market forces of demand and supply.

The demand curve of foreign exchange is downward sloping while the supply curve is upward sloping.

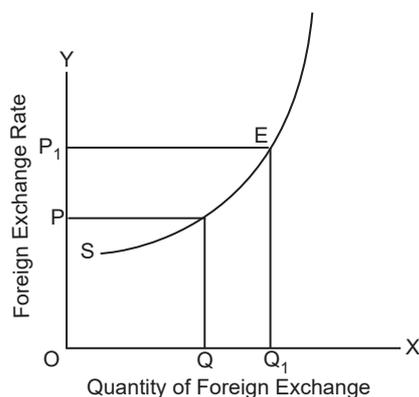
Downward Sloping Demand Curve

There is an inverse relationship between foreign exchange rate and quantity of foreign exchange demanded. Due to inverse relationship, demand curve is downward sloping.



Upward Sloping Supply Curve

Supply curve is upward sloping due to direct relationship between foreign exchange rate and quantity of foreign exchange supplied.



Determination of Foreign Exchange Rate: Under, flexible exchange rate system, the foreign exchange rate is determined by the market forces of demand and supply.

In the figure, the X-axis represents the quantity of foreign exchange demanded and supplied and Y-axis represents price per unit of foreign currency.

The exchange rate is determined at the intersection of demand and supply curve *i.e.* at point E. In the diagram, OP_1 is the exchange rate and OQ_1 is the quantity of foreign exchange demanded and supplied. Any rate above or below this rate is a temporary fluctuations and equilibrium rate is established at the point of intersection of the two curves.

Answer 10.

National Income can be calculated by three methods:

1. Product method
2. Income method
3. Expenditure method

Income method of calculating National Income involves the income generation from all the factors of production in an economy in a given time period.

Following are the steps involved:

STEP I : Identification and classification of producing enterprises.

In this method, all the production units that employ factor inputs are identified *i.e.*

- (a) Primary sector
- (b) Secondary sector
- (c) Tertiary sector

STEP II : Classification of factor income.

Factor income generated in the production unit are classified into the following categories:

- (a) **Compensation of employees:** It includes, wages and salary in cash and kind, employers contribution to social security scheme etc.
- (b) **Operating surplus:** It is the sum of income from property *i.e.* rent , royalty and interest and income from entrepreneurship *i.e.* profits. Profits can be divided into three parts:
 - (i) Dividends
 - (ii) Undistributed profits
 - (iii) Corporate tax

(c) **Mixed income of self-employed:** This is the income of self-employed people that has a mixed characteristics of both compensation of employees and operating surplus. Example-fees charged by a doctor, fees charged by a lawyer.

STEP III: Estimation of domestic factor income (NDP_{fc}).

Factor income paid by each producing unit mentioned above are added to obtain NDP_{fc} . (Domestic income)

$NDP_{fc} = \text{Compensation of employees} + \text{Operating surplus} + \text{Mixed income of self-employed}$

STEP IV: Estimation of National Income (NNP_{fc}).

To calculate National Income, NFIA (Net factor income from abroad) is added to domestic factor income (NDP_{fc}).

$$NNP_{fc} = NDP_{fc} + NFIA$$

Answer 11.

Following are the methods of redemption of public debt:

- (i) **Debt conversion:** Under this system, a high-interest debt is converted into a low interest debt. Sometimes, it happens that the ruling rate of interest is high when the Government contracts the debt. But after some time, the interest rate in the market falls. In such a situation, the government converts its old but high debt so that it reduces the burden of interest on the community. Further, the low-interest rate on public debt also operates in the direction of reducing inequalities in distribution.
- (ii) **Sinking fund:** Under this system, the government establishes a separate fund known as the 'Sinking Fund' for the repayment of the public debt. The government goes on crediting every year a fixed sum of money to this fund. By the time the debt matures, the fund accumulates enough amount to pay off debt.

Two ways of crediting a portion of revenue to this fund:

Firstly, it may credit a fixed percentage of its annual income to this fund. Secondly, the government may raise a new loan and credit the proceeds to the sinking fund.

According to DALTON, a sinking fund should be accumulated out of the current revenue of the government, not out of new loans.

The sinking fund is looked upon as a systematic method of debt redemption. The burden of the debt is spread evenly over a number of years. Further, this method increases the creditworthiness of the government. As against this, the sinking fund method is considered as a slow process of debt repayment.

Answer 12.

- (i) **Commercial Bank:** Commercial bank is defined as an organisation that accepts demand deposits and uses the deposited money to lend to the general public.
- (ii) The regulation of consumer credit involves laying down rules regarding payments and maintaining maximum number of instalment credit for the purchase of specified durable consumer goods.

Thus, consumer credit employs two aspects:

1. Minimum down payment, and
2. Maximum period of payment.

- (iii) Central Bank (Reserve Bank of India in case of India) controls all the commercial banks and financial institutions in our country.