

CBSE
Class XII Economics
Delhi Board Paper Set 3- 2014

Time: 3 hrs

Max. Marks: 100

Note:

- Please check that this question paper contains 12 printed pages.
- Code number given on the right hand side of the question paper should be written on the title page of the answer-book by the candidate.
- Please check that this question paper contains 29 questions.
- **Please write down the Serial Number of the question before attempting it.**
- 15 minutes time has been allotted to read this question paper. The question paper will be distributed at 10.15 a.m. From 10.15 a.m. to 10.30 a.m., the students will read the question paper only and will not write any answer on the answer-book during this period.

General Instructions:

- (i) **All** questions in both the sections are compulsory.
- (ii) Marks for questions are indicated against each question.
- (iii) Questions Nos. **1 – 5** and **17 – 21** are very short-answer questions carrying **1** mark each. They are required to be answered in one sentence each.
- (iv) Questions Nos. **6 – 10** and **22 – 26** are short answer questions carrying **3** marks each. Answers to them should normally not exceed **60** words each.
- (v) Questions Nos. **11– 13** and **27– 29** are also short answer questions carrying **4** marks each. Answers to them should normally not exceed **70** words each.
- (vi) Question Nos. **14 – 16** and **30 – 32** are long-answer questions carrying **6** marks each. Answers to them should normally not exceed **100** words each.
- (vii) Answers should be brief and to the point and the above word limits should be adhered to as far as possible.

SECTION A

1. Define marginal revenue. [1]
2. Unemployment is reduced due to the measures taken by the government. State its economic value in the context of production possibilities frontier: [1]
3. Give meaning of 'returns to a factor.' [1]
4. What is perfect oligopoly? [1]
5. Define indifference curve. [1]

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6. What is the behaviour of average fixed cost as output is increased? Why is it so? [3]
7. State the relation between marginal revenue and average revenue. [3]

OR

State the relation between total cost and marginal cost.

8. Why are the firms said to be interdependent in an oligopoly market? Explain [3]
9. Explain the central problem 'for whom to produce.' [3]
10. A consumer buys 30 units of a good at a price of Rs10 per unit. The price elasticity of demand for the good is (-) 1. How many units the consumer will buy at a price of Rs 9 per unit? Calculate. [3]

11. What is market demand for a good? Name the factors determining market demand. [4]

12. State the behaviour of marginal product in the law of variable proportions. Explain the causes of this behaviour. [4]

13. A consumer consumes only two goods. Explain consumer's equilibrium with the help of utility analysis. [4]

OR

A consumer consumes only two goods A and B and is in equilibrium. Show that when price of good B falls, demand for B rises. Answer this question with the help of utility analysis.

14. From the following information about a firm, find the firm's equilibrium output in terms of marginal cost and marginal revenue. Give reasons. Also find profit at this output. [6]

Output (units)	Total Revenue (Rs)	Total Cost (Rs)
1	7	8
2	14	15
3	21	21
4	28	28
5	35	36

15. Market of a commodity is in equilibrium. Demand for the commodity "increases." Explain the chain of effects of this change till the market again reaches equilibrium. Use diagram. [6]

16. Explain the conditions of consumer's equilibrium with the help of the indifference curve analysis. [6]

OR

Explain the three properties of the indifference curves.

SECTION B

17. Define aggregate supply? [1]
18. Define government budget. [1]
19. What is 'devaluation'? [1]
20. What are demand deposits? [1]
21. Define marginal propensity to consume. [1]
22. Is the following revenue expenditure or capital expenditure in the context of government budget? Give reason. [3]
- i. Expenditure on collection of taxes.
 - ii. Expenditure on purchasing computers.
23. How does giving incentives for exports influence foreign exchange rate? Explain. [3]
24. Define externalities. Give an example of negative externality. What is its impact on welfare? [3]
25. Explain the significance of 'store of value' function of money. [3]
- OR**
- Explain the significance of 'medium of exchange' function of money.
26. Explain the meaning of balance of payments deficit. [3]
27. Calculate investment expenditure from the following data about an economy which is in equilibrium: [4]
- National income = 1500
Autonomous consumption expenditure = 300
Investment expenditure = 300
28. Government raises its expenditure on producing public goods. Which economic value does it reflect? Explain. [4]
29. Define money supply and explain its components. [4]
- OR**
- Explain the 'lender of last resort' function of central bank.

30. Giving reason explain how should the following be treated in estimating gross domestic product at market price? [6]

- i. Fees to a mechanic paid by a firm.
- ii. Interest paid by an individual on a car loan taken from a bank.
- iii. Expenditure on purchasing a car for use by a firm.

31. Explain national income equilibrium through aggregate demand and aggregate supply. Use diagram. Also explain the changes that take place in an economy when the economy is not in equilibrium.

OR

Outline the steps required to be taken in deriving saving curve from the given consumption curve. Use diagram. [6]

32. Calculate national income and gross national disposable income from the following: [6]

	(Rs Arab)
i. Net current transfers to abroad	5
ii. Government final consumption expenditure	100
iii. Net indirect tax	80
iv. Private final consumption expenditure	300
v. Consumption of fixed capital	20
vi. Gross domestic fixed capital formation	50
vii. Net imports	(-)10
viii. Closing stock	25
ix. Opening stock	25
x. Net factor income to abroad	10

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SECTION A

Answer 1

Marginal revenue is the additional revenue earned from the sale of additional unit of output.

Answer 2

As the government implements various schemes to overcome the unemployment situation in an economy, there will be an increase in the employment level. So, the point which was within the production possibility curve (PPC) will become closer to PPC. This implies that the economy is operating on the PPC with better utilisation of resources and hence increased level of output and income.

Answer 3

If an additional unit of variable input is utilised in the production process, then there will be a change in the level of output. This is called returns to a factor. This is also known as the law of variable proportions or law of diminishing returns.

Answer 4

Perfect oligopoly is a form of market in which firms produce homogeneous products. These products are in the same size, colour and shape and have perfect substitutes for each other.

Answer 5

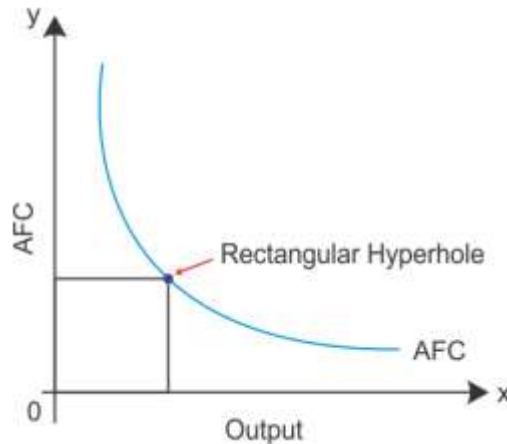
An indifference map represents a set of indifference curves which shows the various preferences of a consumer. Indifference curves on the indifference map do not intersect each other because consumers have various preferences with respect to their different levels of income.

Answer 6

Average fixed cost is the fixed cost per unit of output. Average fixed cost curve slopes downward to the right. It shows that AFC decreases as output increases. It is a rectangular hyperbola curve. It means that the product of AFC and output is equal to TFC which remains constant at all levels of output.

$$TFC = AFC * Q$$

$$\text{Therefore, } AFC = \frac{TFC}{Q}$$

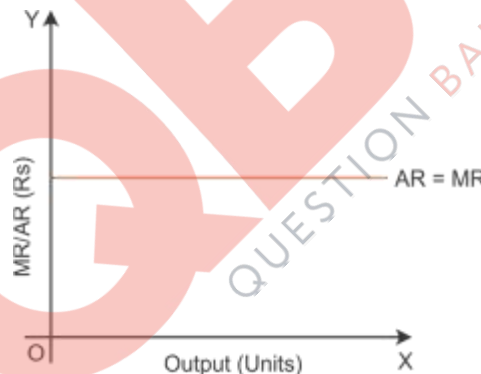


Answer 7

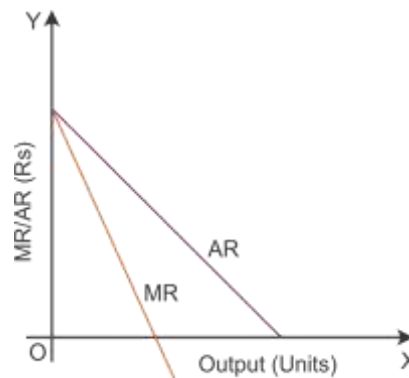
Marginal Revenue (MR) and Average Revenue (AR):

The relationship between MR and AR can be explained through two forms of market, i.e. perfect competition market and imperfect competition market.

- i. Under the perfect competition market, AR is equal to MR at all levels of output. Hence, the MR curve is a straight horizontal line which is parallel to the X-axis and coincides with the AR curve.



- ii. Under the imperfect competition market, as the output or sales increases, both AR and MR curves decline. However, AR remains greater than MR at all levels of output. Also, when AR becomes zero, the MR will be negative.



OR

Marginal Cost (MC) and Total Cost (TC):

Marginal cost (MC) is the difference between total cost (TC) incurred for producing unit 1 and unit 2 of output.

$$MC_n = TC_n - TC_{n-1}$$

where

MC_n = Marginal cost of producing 'n' units of output

TC_n = Total cost of producing 'n' units of output

TC_{n-1} = Total cost of producing 'n - 1' units

TC is the total cost of production which is incurred in the production process by the firm in the short run.

$$TC = \sum MC$$

If the MC is declining, then TC increases at a decreasing rate. On the other hand, if the MC is rising, then TC increases at an increasing rate. If the MC attains its lowest point, then the TC will not increase even at a decreasing rate.

Answer 8

In an oligopoly market, the price and level of output of one firm impact the price and level of output of rival firms. Keeping this impact in mind, a firm decides the price and output in accordance with prevailing market conditions. Hence, a high degree of interdependence exists among competing firms, especially with regard to price and quantity of output.

Answer 9

Central problem - 'For whom to produce':

'For whom to produce' refers to the problem of distribution of final goods and services or the problem of distribution of income. It has two aspects. The first aspect relates to personal distribution and the second aspect relates to functional distribution. Personal distribution refers to output/income share of individuals or households in society. Functional distribution refers to income share of different factors of production. Here, the problem is whether allocation of resources is promoting equality or not. Equality is a social virtue, and inequality may induce high saving, investment and hence high rate of growth.

Answer 10

Given that

$$Q_1 = 30$$

$$Q_2 = ?$$

$$P_1 = \text{Rs}10$$

$$P_2 = \text{Rs}9$$

$$e_d = -1$$

$$E_d = \frac{\Delta Q}{Q} \times \frac{P}{\Delta P}$$

$$-1 = \frac{(Q_2 - Q_1)}{Q_1} \times \frac{P}{\Delta P}$$

$$-1 = \frac{(Q_2 - 30)}{30} \times \frac{10}{(-1)}$$

$$3 = Q_2 - 30$$

$$Q_2 = 33$$

Hence, the consumer will buy 33 units of the good at a price of Rs 9.

Answer 11

Market demand is the horizontal summation of the individual demand. It indicates various quantities of a good which all the consumers in the market are willing to buy at different possible prices of a good at a point of time.

Factors determining the market demand of a commodity:

- i. **Own price of good:** Assuming that other things remain constant, an increase in the price of a good will decrease the demand for a good, and a decrease in the price of a good will increase the demand for a good. There is an inverse relationship between the price of a good and the demand for a good.
- ii. **Price of other goods:** Demand for a commodity is influenced by a change in the price of other goods. When the price of one good falls, it becomes cheaper in relation to another good.

If there is an increase in the price of the substitute good coffee, then the demand curve for tea shifts to the right. On the other hand, if there is a decrease in the price of the substitute good coffee, the demand curve for tea shifts to the left even when its price is constant.

If there is an increase in the price of a good, then the demand for another good will decline. So, the demand curve shifts parallel to the left. On the other hand, if there is a decrease in the price of a good, then the demand for another good will increase, and so, the demand curve shifts parallel to the right.

- iii. **Income of consumers:** A change in income causes a change in demand for good based on the variety of goods available in the market. There will be an increase in the demand

for normal goods with a rise in income level. On the other hand, the demand will decrease for inferior goods with an increase in income.

- iv. **Consumers' tastes and preferences:** Assuming that other things remain constant, if consumers have more preference for one good than other goods, then the demand for that good will increase. On the other hand, if consumers have no preference for a good than other goods, then the demand for that good will decrease.
- v. **Population size:** An increase or decrease in population size will influence the demand for goods in the market. There is a positive relationship between the size of population and the demand for a good.

Answer 12

Law of variable proportion:

Law of variable proportion states that as more of the variable factor input is combined with the fixed factor input, a point will eventually be reached where the marginal product of the variable factor input starts declining.

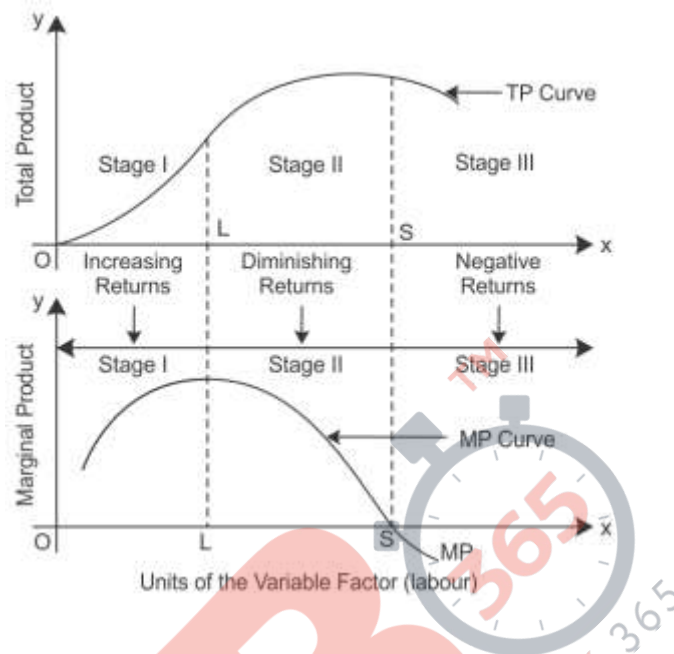
Units of Fixed Factor	Units of Variable Factor	TP	MP	Stages
1	1	4	4	Increasing MP (Increasing returns to a factor)
1	2	12	8	
1	3	24	12	
1	4	32	8	Diminishing MP (Diminishing returns to a factor)
1	5	34	2	
1	6	34	0	
1	7	30	-4	Negative MP (Negative returns to a factor)
1	8	21	-9	
1	9	10	-11	

Let us consider the above table.

Stage I: As more units of factor input are used, MP tends to rise till 3 units of factor input are used. Here, the total product increases at an increasing rate which is called increasing returns to the factor input.

Stage II: However, when the 4th unit of factor input is used, the diminishing returns sets in where MP starts decreasing and TP increases at a decreasing rate. Diminishing MP reduces to zero. The total output is the maximum when the marginal output is zero.

Stage III: When MP is negative, TP starts declining from 34 to 10 when the 9th unit is employed.



Answer 13

Conditions of consumer's equilibrium using marginal utility analysis:

When a consumer buys both Goods X and Y, the consumer's equilibrium condition is expressed through the equation:

$$\frac{MU_x}{P_x} = \frac{MU_y}{P_y} = \frac{MU_m}{P_n} = MU_m$$

Consider the following numerical example to understand the consumer's equilibrium using marginal utility. A consumer Marginal Utility of Money (MU_m) is 16 utils and two Goods X and Y whose prices are Rs 1 (P_x) and Rs 1 (P_y) per unit, respectively. Consider the following schedule to analyse marginal utility of good x (MU_x) and good y (MU_y).

Units of x	MU x (Utils)	MU y3 (Utils)
1	28	32
2	24	29
3	21	27
4	20	23
5	16	20
6	13	18
7	9	17
8	5	16
9	3	12
10	1	9

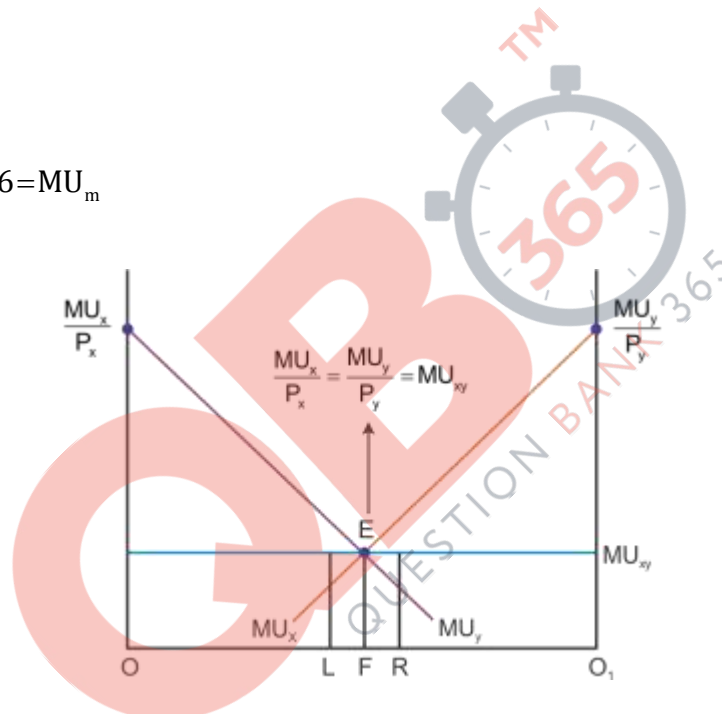
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Based on the given schedule, the consumer is in equilibrium at the consumption of 5 units of commodity x and 8 units of commodity y. At such a consumption combination, the marginal utility of a rupee spent on the commodity x $\left(\frac{MU_x}{P_x}\right)$ is equal to the marginal utility of a rupee spent on the commodity y $\left(\frac{MU_y}{P_y}\right)$ and also equal to the marginal utility of money (MU_m).

Marginal utility of a rupee spent on commodity x = marginal utility of a rupee spent on commodity y = Marginal utility of money

$$\frac{MU_x}{P_x} = \frac{MU_y}{P_y} = MU_m$$

$$\frac{MU_x}{P_x} = \frac{MU_y}{P_y} = \frac{16}{1} = 16 = MU_m$$



In the diagram, OO_1 is the total income of a consumer. MU_x and MU_y are the marginal utility curves of commodity x and commodity y, respectively.

The consumer does not attain equilibrium at Point L because the point at L is

$$\frac{MU_x}{P_x} > \frac{MU_y}{P_y}$$

The consumer does not attain equilibrium at Point R because the point at R is

$$\frac{MU_x}{P_x} < \frac{MU_y}{P_y}$$

So, when OF amount of income is spent on commodity x and FO_1 amount is spent on commodity y, the consumer is in equilibrium at Point E. Hence, at this point

$$\frac{MU_x}{P_x} = \frac{MU_y}{P_y} = MU_m$$

OR

Utility Analysis:

The consumer reaches equilibrium only if the following condition is satisfied

$$\frac{MU_A}{P_A} = \frac{MU_B}{P_B}$$

Give that the utility received from each additional unit of the money spent on both the goods should be equal. Marginal utility of the amount spent on good A is equal to the marginal utility of the amount spent on good B and also equal to marginal utility of money.

$$\frac{MU_A}{P_A} = \frac{MU_B}{P_B} = MU_m$$

If the price of good B falls in relation to good A, the consumer will buy more of good B.

$$\frac{MU_B}{P_B} > \frac{MU_A}{P_A} = MU_m$$

The consumption of good B will tend to increase till the equality is established between the marginal utilities of both the goods become equal to the marginal utility of money.

Answer 14

Output (units)	Total Revenue (Rs)	Total Cost (Rs)	Marginal Revenue (Rs)	Marginal Cost (Rs)	Profits (TR – TC)
1	7	8	-	-	-1
2	14	15	7	7	-1
3	21	21	7	6	0
4	28	28	7	7	0
5	35	36	7	8	-1

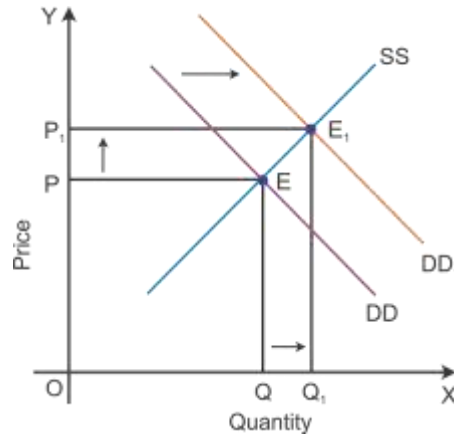
The producer's equilibrium refers to the situation in which he maximises his profits. A producer strikes equilibrium when two conditions are satisfied:

- MR = MC
- MC is rising or the MC curve cuts the MR curve from below.

The table indicates that the two conditions of equilibrium are satisfied only when 4 units of output are produced. It is here that (i) MR = MC = Rs 7 and (ii) MC is rising.

Answer 15

Consider DD to be the initial demand curve and SS to be the supply curve of the market. Market equilibrium is achieved at Point E, where the demand and supply curves intersect each other. Therefore, the equilibrium price is OP, and the equilibrium quantity demanded is OQ.



When there is an increase in income of consumers, consumers would tend to spend more on normal goods than the inferior goods where the prices of all goods, tastes and preferences remain constant. There will be a shift in the demand curve towards the right to DD₁ with an increase in the demand, and the supply curve SS will remain the same. This implies that at the initial price OP₁, there is an excess demand of OQ to OQ₁ units at the initial price OP.

Because of an increase in the demand, there will be an increase in competition among buyers. So, they would be willing to pay more prices to obtain more units of a good in the market. Hence, there will be an increase in the market price to OP₂. Now, the new market equilibrium will be at Point E₁, where the new demand curve DD₁ intersects the supply curve SS.

This clearly states that if the demand curve shifts towards the right, the price of the good tends to increase with an increase in the demand for a good. Thus, the direction of change in equilibrium price and quantity is the same whenever there is a shift in the demand curve.

Answer 16

Conditions of consumer's equilibrium using indifference curve analysis:

A consumer will strike his equilibrium at the point where the budget line is tangent to an indifference curve.

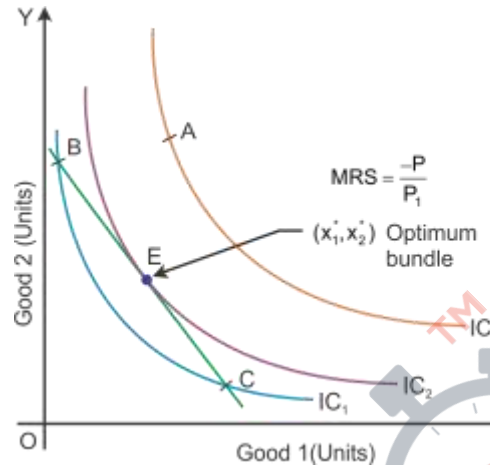
Slope of IC = Slope of price line

$$\left| \frac{-dy}{dx} \right| = |MRS| = \left| \frac{-P_1}{P_2} \right|$$

Equality of marginal rate of substitution and ratio of prices: When the budget lines is tangent to an indifference curve at a point, the absolute value of the slope of the indifference curve and of the budget line are equal at that point, i.e. MRS is equal to the price ratio. The slope of the budget line is the rate at which the consumer can substitute one good for the other in the market. At the optimum, the two rates should be the same.

Thus, a point at which the MRS is greater, the price ratio cannot be optimum, and when the MRS is less than the price, the ratio cannot be optimum.

The equilibrium can be represented as follows:



In the diagram, Point E shows the consumer's equilibrium where the budget line is tangent to the indifference curve. Consumers' desire to purchase correspond to the consumer originally purchase, i.e. x_1^* , x_2^* shows the optimum bundle.

Consumer does not reach equilibrium condition at the following points:

At Point B: $MRS > -\frac{P_1}{P_2}$

At Point A: $MRS < -\frac{P_1}{P_2}$

OR

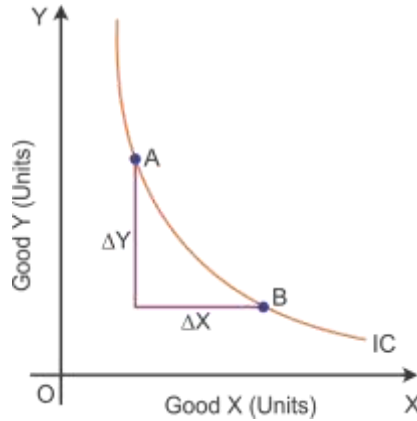
Properties of indifference curves (ICs)

i. Indifference curves slope downwards or negative slope:

The indifference curves slope downwards, left to right, because an increase in the amount of Good X along the indifference curve is associated with a decrease in the amount of Good Y, as the preferences are monotonic.

ii. Slope of indifference curves represents marginal rate of substitution:

Marginal rate of substitution (MRS) is the rate at which a consumer is willing to substitute one commodity for another commodity.



Slope of indifference curve between A and B = $\frac{\Delta Y}{\Delta X} = \text{MRS}$

MRS is the rate at which the output of Good Y is sacrificed for every additional unit of Good X.

iii. In an indifference map, higher IC represents higher level of satisfaction:

An indifference map refers to a set of indifference curves. An indifference curve which is to the right and above another shows a higher level of satisfaction to the consumer. Here, IC₃ shows higher level of satisfaction than IC₂. Thus, the indifference curve relates to a higher level of income of the consumer.



SECTION B

Answer 17

Aggregate supply means the total production of goods and services in the country at a given level of employment during the year.

Answer 18

A government budget is a financial statement of expected receipts and payments of government during a particular period of time, such as a financial year 1st April XX–31st March XX.

Answer 19

Devaluation means a reduction in the price of domestic currency related to all foreign currencies in a fixed exchange rate system.

Answer 20

Demand deposits are not for any specific period of time. They can be withdrawn as and when required. These deposits are chequable deposits.

Answer 21

Marginal Propensity to Consume (MPC) is the ratio of change in consumption (ΔC) to change in income (ΔY) i.e. $MPC = \frac{\Delta C}{\Delta Y}$

Example:

$$\Delta Y = \text{Rs } 500$$

$$\Delta C = \text{Rs } 100$$

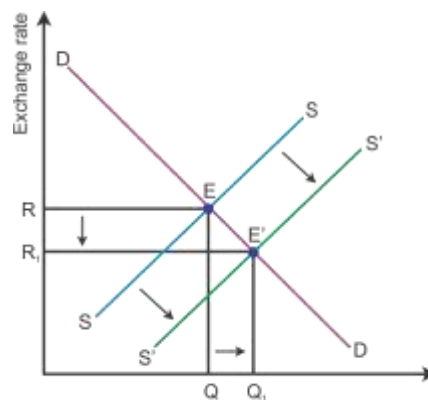
$$MPC = c = \frac{\Delta C}{\Delta Y} \\ = \frac{100}{500} = 0.2$$

Answer 22

- i. Expenditure on collection of taxes is revenue expenditure. This expenditure has no decline in government liabilities and does not create assets for the government. For example, salaries, pensions and interest payments.
- ii. Expenditure on purchasing computers is capital expenditure. This expenditure has a decline in government liabilities and creates assets for the government. For example, purchase of shares and bonds.

Answer 23

The incentive for exports will lead to an increase in exports, and hence, there is an increase in the supply of foreign exchange. Assuming other things remain constant, an increase in the supply of foreign exchange will reduce the foreign exchange rate. Hence, this is reflected by a shift in the supply curve as shown below.



DD and SS are the initial demand and supply curves of foreign currency, respectively. As there is a decline in the demand for foreign exchange rate, the new equilibrium is established at Point E'. Here, it states that the currency appreciates with a fall in the exchange rate from OR to OR₁, and the demand and supply of foreign currency rises to OQ₁.

Answer 24

Externality is a positive and negative impact on economic activity on the others without involving any price. For example, emissions from driving contribute significantly to global warming. This leads to poor air quality and it contributes to significant health problems. People who breathe in this polluted air are at a higher risk for asthma and damage to the reproductive system. Thus, it affects the health of the people, which in turn reduces the welfare of the nation.

Answer 25

Store of Value

People keep their wealth in the form of money because money is the most liquid form of wealth. Savings in the form of money is maintained for purchasing commodities in the future. In this case, the values of commodities are being stored. Hence, money acts as a store of value.

However, the store of value is completely absent under the barter system. Wealth is stored in terms of goods as there was no money in existence. There were many problems such as storage of goods cost, loss of value and movement of transfer. Hence, it is not practically possible to store people's purchasing power.

Money facilitates exchange beyond limits. Here, the store of value function does not create value loss over a period of time.

OR

Medium of exchange: The primary function of money is to act as a medium of exchange between two parties involved in a transaction. It avoids the practical problems of wastage of time and resources involved in the barter system of exchange and it improves the efficiency of the transaction. It promotes allocation efficiency in the trade and production of goods and services.

For the barter system, the sale and purchase of goods occurs at the same time. Their sale and purchase value also remains equal at that point. A person can purchase or sell goods with cash without selling or purchasing any good at that point, after money came into existence. Thus, the act of purchase and sale has been separated. Thereby the medium of exchange facilitated sale and purchase very easily in terms of monetary value.

Answer 26

Deficit in balance of payments is when receipts of the country coming from autonomous transactions are less than the corresponding payments to the rest of the world during the period of an accounting year. It shows net liabilities towards the rest of the world.

There are certain positive and negative impacts of deficit in balance of payment. When deficit occurs on account of capital import which is required for advancing the process of growth and development, it is a positive impact of deficit in balance of payment. Negative impact is that it shows Indian liabilities to the rest of the world. These liabilities strain the GDP by making payments to the rest of the world.

Answer 27

As we know that

$$Y = C + I$$

where

$$I \text{ (Investment expenditure)} = 300$$

$$Y \text{ (National income)} = 1500$$

$$C = \bar{C} + cY$$

where

$$\bar{C} \text{ (autonomous expenditure)} = 300$$

c = marginal propensity to consume

Thus, applying all the values in equation

$$C = \bar{C} + cY + I$$

$$1500 = 300 + c \times 1500 + 300$$

$$c = \frac{1500 - 600}{1500} = 0.6$$

Thus, marginal propensity to consume is 0.6.

Answer 28

The government expenditure on producing public goods increases the welfare of the nation. Through the budgetary policy, the government can reallocate resources so that social and economic objectives can be met in the following ways:

- i. The government ensures productive expenditure to maximise the welfare of the nation with minimum level of profit.
- ii. The government regularises the activities of the private sector to provide social benefit to the poor.

Answer 29

Money supply is the total stock of money in circulation among the people at a particular point of time.

Money supply consists of various components as follows:

Currency, demand and time deposits in commercial banks and other types of deposits are the total amount of money in an economy. Definition of supply of money varies depending on the components which are included and excluded.

Money supply = Currency with the public + Demand deposits with commercial banks + Deposits kept by commercial banks with the Reserve Bank

$$M1 = C + DD + OD$$

Currency with the public includes notes and coins issued by the government authority of India on the basis of the minimum reserve system.

Demand deposits with commercial banks are current account deposits with banks or other financial institutions which are payable on the demand by cheques. Banks do not provide interest payments on deposits.

OR

A Central Bank is the apex bank which controls the entire banking system of a country. It has the sole authority to issue notes in that country. It also acts as a banker to the government and controls the supply of money in the country.

The Central Bank provides financial assistance to commercial banks by rediscounting eligible bills of exchange. When commercial banks do not get loan facilities from any other sources, they approach the Central Bank as a last resort. The Central Bank advances loans to such banks against approved securities. Thus, the Central Bank acts as a 'lender of the last resort'.

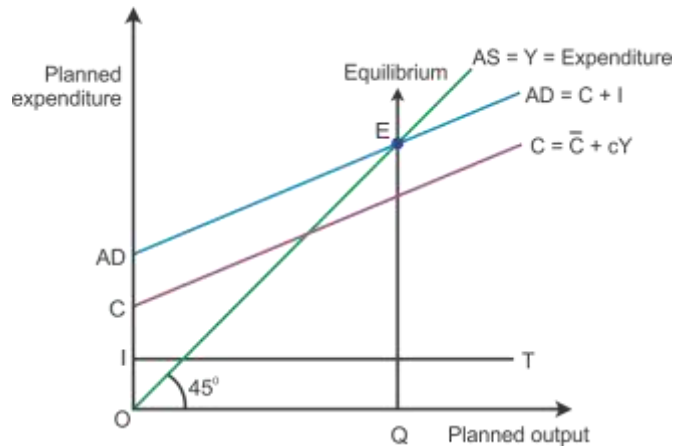
Answer 30

- i. A fee paid to a mechanic by a firm **is not included** in the estimation of gross domestic product at market price because it is only an intermediate expenditure for the firm.
- ii. Interest paid by an individual on a car loan taken from a bank **is not included** in the estimation of the gross domestic product at market price because the car loan was taken only for consumption purpose.
- iii. Expenditure on purchasing a car for use by a firm **is included** in the estimation of the gross domestic product at market price because the purchased car is the final investment expenditure of the firm.

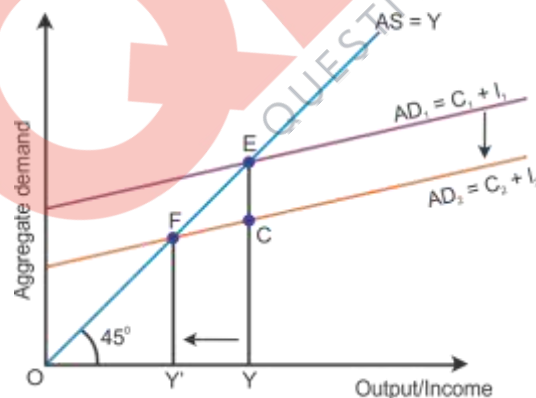
Answer 31

Aggregate demand and aggregate supply approach (AD and AS approach)

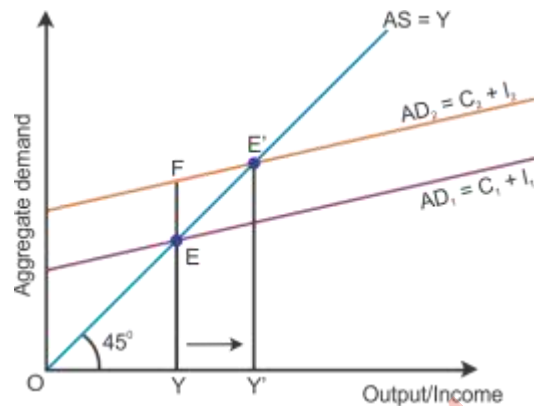
Equilibrium level of income is attained only when aggregate demand is equal to aggregate supply. It is the level of output where producers plan to produce the amount of good is equal to consumers plan to purchase the amount of good. Thus, equilibrium is struck where planned output (AS) is equal to planned expenditure (AD) during a period of time.



Deficient demand occurs in a situation when the aggregate demand is short of the aggregate supply corresponding to full employment in the economy. It leads to a fall in the general price level and results in deflation, i.e. $AD < AS$. Aggregate demand is shown by the AD curve and aggregate supply is shown by the AS curve (as shown in the diagram below). While the aggregate demand curve and the aggregate supply curve intersect each other, the full employment equilibrium is attained at Point E. OY is the full employment level of output, and EY is the aggregate demand at full employment level of output. If the aggregate demand decreases below the full employment level of output from EY to CY, then the economy will have **deficient demand**, ($EY - CY = EC$).

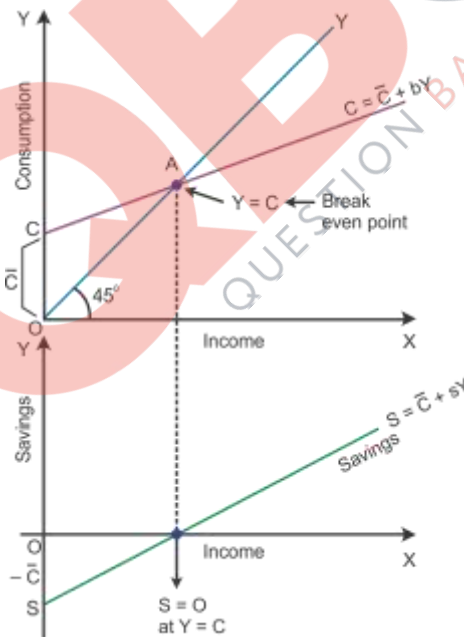


Excess demand occurs in a situation when aggregate demand is more than aggregate supply corresponding to full employment. It leads to reduction in inventories and inflation in the economy. This situation is considered an inflationary gap—the difference between aggregate demand beyond full employment and aggregate demand at full employment. Aggregate demand is the AD curve and aggregate supply is the AS curve (as shown in the diagram below). While the aggregate demand curve and the aggregate supply curve intersect each other, the full employment equilibrium is attained at Point E. OY is the full employment level of output, and EY is the aggregate demand at full employment level of output. If the aggregate demand increases beyond the full employment level of output from EY to FY, then the economy will have **excess demand** ($FY - EY = FE$).



OR

In the diagram, the consumption curve is given as $\bar{C} + bY$, where $\bar{C}$ represents the autonomous consumption, Y is income and b is the rate at which C increases corresponding to an increase in Y. The aggregate supply curve is the 45° line. Consumption is equal to income at Point E.



Derivation of saving function from consumption function:

— $\bar{C}$ is the saving function where negative savings are equal to autonomous consumption at $Y = 0$. This is shown on the negative axis in the lower panel at Point S. Here, all the income is spent on consumption expenditure. Hence, there is no saving which is shown as the breakeven point. After this point, S and Y are joined to have a straight line sloping curve.

Answer 32

National domestic income at factor cost = Private final consumption expenditure + Government final consumption expenditure – Net imports + (Gross domestic fixed capital formation + Closing stock – Opening stock) – Depreciation – Net indirect taxes

Or

National income (NDP_{FC}) = $300 + 100 - (-10) + (50 + 25 - 25) - 20 - 80 =$
Rs 360 arab

Net national disposable income = $NDP_{FC} - \text{Net factor income to abroad} + \text{Net indirect taxes} + \text{Net current transfers from ROW}$

Net national disposable income = $360 - 10 + 80 + (-5) =$ Rs 425 arab

