Q. P-code 70026

Model Answer

Q.1 Attempt any two of the following.

a. What is Money? Explain the various ~~functions~~ determinants of the money of supply

- Money may be defined as 'anything which is generally acceptable by the people in exchange of goods and services or in repayment of debts.'

  ~~**Functions of Money:**~~ Determinants of Money supply

  ~~1. Primary Functions: 2. Secondary Functions: 3. Contingent Functions: 4. Other Functions~~

  1) HPM (2) Community Choice (3) CRR (4) velocity of circulation of money etc.

b. Discuss the Fisher's cash transaction approach to money.

- The quantity theory of money also known as cash transaction approach. This states that the quantity of money is the main determinant of the price level or the value of money.
- Any change in the quantity of money produces an exactly proportionate change in the price level.
- Fisher s Equation of exchange: PT=MV+ M' V'
- Assumptions of the Theory
- Explanation with diagram.

c. Explain the factors affecting on velocity of circulation of money.

Velocity of Circulation refers to the average number of times a single unit of money changes hands in an economy during a given period of time.

Factors Affecting Veiocity of Circulation

- Money Supply
- Frequency of Transactions
- Regularity of Income
- Payment System
- There are several other factors

Q.2 Attempt any two of the following.

a. Discuss the Keynesian motives of demand for money.

- Keynes in his General Theory used a new term "liquidity preference" for the demand for money. Keynes suggested three motives which led to the demand for money in an economy:

(1) Transactions Motive

Proportionally depend upon level of income : $L_T = f(Y)$

(2) Precautionary Motive

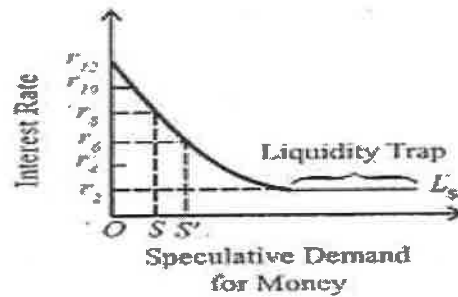
Proportionally depend upon level of income: $L_P = f(Y)$

(3) Speculative Motive -

Inversely depend upon rate of interest: $L_S = f(r)$

b. Explain the concept of 'Liquidity Trap'.

- At a very low rate of interest, such as r_2, the Ls curve becomes perfectly elastic and the speculative demand for money is infinitely elastic. This portion of the Ls curve is known as the **liquidity trap.**

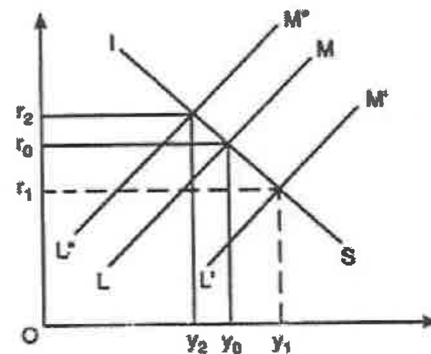


c. Describe the shifts in LM curve in the money market equilibrium.

- The LM curve is a locus of points showing all combinations of r and Y which equilibrate the money market.

Shifts in the LM Curve:

- An increase in money supply shifts the LM curve to toe right and reduces toe rate of interest. This raises investment in the commodity market. Income consequently rises.
- Similarly an increase in the demand for money, for instance, raises the rate of interest by shifting the LM curve leftward; investment falls and so income.



Q.3 Attempt any two of the following.

a. Explain the investment demand function.

- I = f (MEC, i) where, I stands for investment demand, MEC refers to the marginal efficiency of capital and i stands for the rate of interest.
- rate of interest falls, investment demand rises and vice versa.
- investment demand schedule
- Explanation with diagram.

b. write a note on concept of 'animal spirit'.

- **'Animal spirits'** – it refers to the confidence and the 'gut instincts' of businessmen on their future business prospects.
- It is a term coined by the economist John Maynard Keynes, who explained how the economic cycle could be volatile because of the changing 'spirits' of the businessmen involved.
- Keynes was trying to say that raw economic data such as profit levels may be inadequate. For example, profits may be high, but, if businessmen fear a recession then investment is likely to dry up.
- Animal spirits may also refer to the risk involved in taking investment decisions which invariably have an element of risk attached.

c. Derive the IS curve from the goods market equilibrium IS Curve.

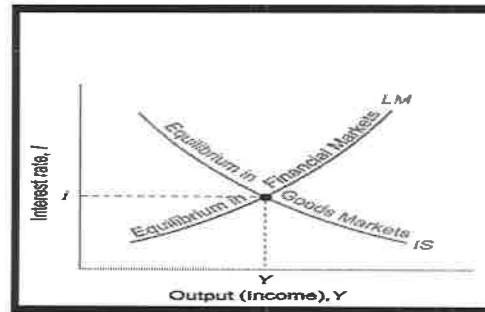
- The IS curve is the locus of those combinations of rate of interest and the level of national income at which goods market is in equilibrium.
- It will be observed from Fig. that the IS curve is downward sloping (i.e., has a negative slope)

• which implies that when rate of interest declines, the equilibrium level of national income increases.
• Goods Market Equilibrium: IS Curve
• Explanation with diagram.

Q.4 Attempt any two of the following. 20

a. Describe the general equilibrium in the goods and money market with the help of IS- LM model.

• Equilibrium in the goods market (*IS*).
• Equilibrium in financial/ money markets (*LM*).
• When the *IS* curve intersects the *LM* curve, both goods and financial markets are in equilibrium
• At equilibrium point national output and rate of interest both are determined.



b. Discuss the quantitative measures of monetary policy.

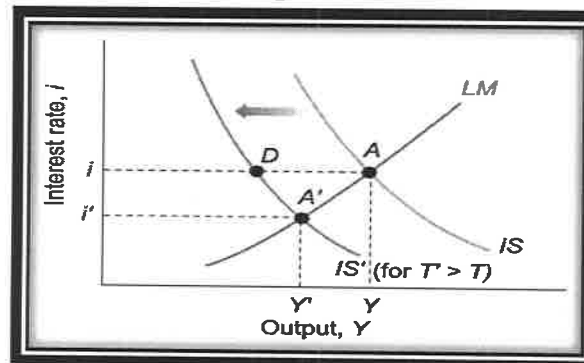
• Monetary policy refers to the steps taken by the RBI to regulate the cost & supply of money & credit in order to achieve the socio-economic objectives of the economy.
• **Two types measures :-** Quantitative measures and qualitative measures
• **Quantitative measures**
• A) Bank Rate
• B) Open Market Operation
• C) Changes in Reserve Ratios – Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR)

c. Explain the effectiveness of fiscal policy under IS-LM model.

⌗ ***Fiscal contraction***: a fiscal policy that reduces the budget deficit.
  ■ Reducing G or increasing T
⌗ ***Fiscal expansion***: increasing the budget deficit.
  ■ Increasing G or decreasing T

Taxes (T) and government expenditures (G) affect the *IS* curve, not the *LM* curve

• **Change in fiscal policy: change the output and interest rate**



(3)

Q.5 Attempt any two short notes of the following.

a. Money Multiplier.

The Money Multiplier refers to how an initial deposit can lead to a bigger final increase in the total money supply.

$$\text{Money Multiplier} = \frac{\text{Change in total money supply}}{\text{Change in monetary base (reserves)}}$$

For example, if the commercial banks gain deposits of £1 million and this leads to a final money supply of £10 million. The money multiplier is 10.

The money multiplier is a key element of the fractional banking system.

1. There is an initial increase in bank deposits (monetary base)
2. The bank holds a fraction of this deposit in reserves and then lends out the rest.
3. This bank loan will, in turn, be re-deposited in banks allowing a further increase in bank lending and a further increase in the money supply.

$$\text{Money Multiplier} = \frac{1}{\text{Reserve Ratio}}$$

b. Saving Function

- Saving is that part of income which is not spent on current consumption. The relationship between saving and income is called saving function.

Symbolically,

S = f (Y)

Algebraically:

S = Y-C

$$S = Y - C$$
$$= Y - (\bar{C} + bY) \qquad (\because \bar{C} = bY)$$
$$= Y - \bar{C} - bY$$
$$S = -\bar{C} + (1-b)Y$$

c. LM curve

- The money market is in equilibrium when the demand for money indicated by symbol L is equal to the fixed (exogenously determined) supply of money M.
- The LM curve is a locus of points showing all combinations of r and Y which equilibrate the money market.
- Money Market Equilibrium and LM Curve
- Explanation with diagram.

d. Fiscal policy instruments

- It refers to the Revenue and Expenditure policy of the Govt. which is generally used to cure recession and maintain economic stability in the country.
- **Instruments of Fiscal Policy:**
- 1. Reduction of Govt. Expenditure
- 2. Increase in Taxation
- 3. Imposition of new Taxes
- 4. Wage Control
- 5.Rationing
- 6. Public Debt
- 7. Increase in savings
- 8. Maintaining Surplus Budget