NEXT IAS

TEST-5

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PAPER-1

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Q. No.	Page No.	Max. Marks	Marks	Total	Signature
1.(a)	4	10			
1.(b)	4	10			
1.(c)	4	10			
1.(d)	4	10			
1.(e)	4	10			
2.(a)	14	20			
2.(b)	18	15			
2.(c)	21	15			
3.(a)	24	15			
3.(b)	27	20			
3.(c)	31	15			
4.(a)	34	10			
4.(b)	36	20			
4.(c)	40	20			
5.(a)	44	10			
5.(b)	44	10			
5.(c)	44	10			
5.(d)	44	10			
5.(e)	44	10			
6.(a)	54	20			
6.(b)	58	20			
6.(c)	62	10			
7.(a)	64	20			
7.(b)	68	15			
7.(c)	71	15			
8.(a)	74	15			
8.(b)	77	15			
8.(c)	80	20			
Grand Total					

Remarks

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Observations:

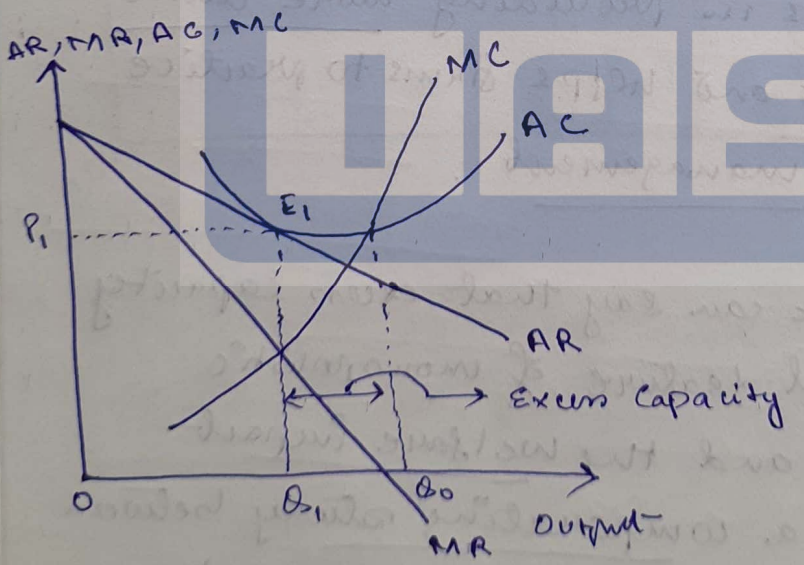
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Q1 a)

The excess capacity is a typical feature of monopolistic competition. Comment.

→ In a monopolistic competition, the firm is a price maker but since there are other firms in the market, it chooses a price within a given range so that it don't lose the market. Therefore the AR curve of the firm is downward sloping and above MR curve.

Thus firms doesn't produce at the minimum of LRAC.



Here, at E_1, MR = MC and P > MR ⇒ P > MC

And at minimum of AC, MC = AC.

Normal profit is P = AC but here it is not at minimum of AC.

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The minimum of AC is at Q_0 but equilibrium is at Q_1. The difference between Q_0 and Q_1 is Excess capacity.

The implication of excess capacity is that firms has extra/more unit to produce for optimum but the firms produces relatively less to maximize profit.

Excess capacity has been criticized for wastage of resources creating social wastage. However, it creates largest variety of products which helps in providing more choice in market and helps firms to practice inventory management.

Therefore, we can say that excess capacity is a typical feature of monopolistic competition and the welfare impact should be a comparative study between the losses and the benefits due to excess capacity.

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Q1
b). The impact of overtime wage on labour supply depends whether it is paid at, above or below the initial equilibrium choice? Explain.

→ The impact of overtime wage on labour supply depends whether it is paid at, above or below the initial equilibrium choice.

Case I.

If overtime wage is paid at the point of initial choice of labour then we have only substitution effect and zero income effect.

Thus increase in consumption is only possible if the individual chooses to work more.

Therefore, it will lead to reducing leisure hours.

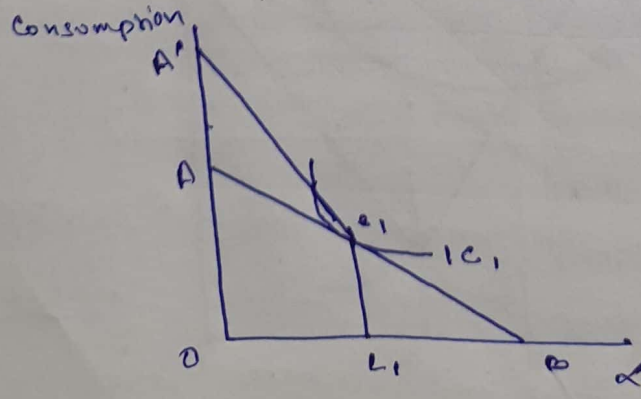


Fig 1

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As shown in fig 1, if initial choice is e_1, individual will not choose any bundle to the right of e_1 as it will violate the assumption of Reflexivity. Thus, the individual will choose to the left of e_1 which decreases choice of leisure.

Case II: If overtime wage is offered after higher hours of work compared to initial choice of labour then it is possible that there is no change in equilibrium. (Fig 2)

Case III: If the overtime wage is offer from work hours below the equilibrium choice then both income and substitution effect applies and it is possible that individual reduces labour hours as compared to initial choice (Fig 3).

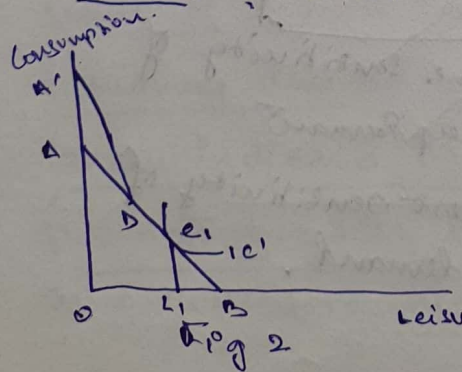


Fig 2

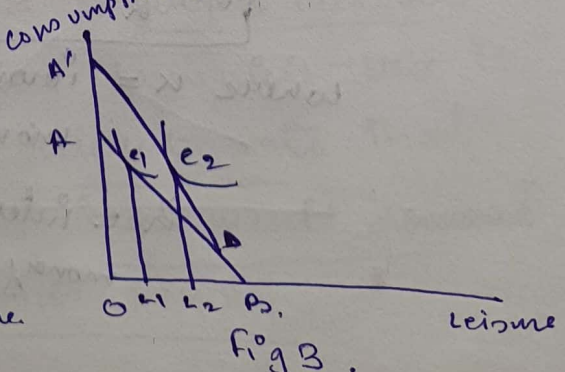


Fig 3.

Thus impact depends on position from initial equilibrium choice.

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Q1 c) Explain the reasons that weaken the transmission mechanism.

→ Transmission mechanism is the method by which changes in money market have an impact on equilibrium in goods market.

The equilibrium in goods market is represented by IS curve given by the equation : $\boxed{i = \frac{\bar{A}}{b} - \frac{Y}{\alpha_G b}}$

where i = interest rate

b = sensitivity of investment to interest rate

α_G = Autonomous government multiplier.

Equilibrium in money market is given by LM curve given by equation

$$\boxed{i = \frac{1}{h}\left[kY - \bar{M}/\bar{P}\right]}$$

where k = income sensitivity of money demand

h = interest sensitivity of money demand.

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Reasons that weaken the transmission mechanism. (TM)

① Higher k will result in weaker TM.

This is because if 'k' is high then for a given increase in money supply, interest rate will fall by a lesser value to bring money market back in equilibrium. If interest rate falls by a lesser value then investment demand will rise by lesser value and therefore output will rise by lesser value.

② Higher k will result in weaker T.M.

A higher k will imply that in the 2nd stage of T.M. when investment rises and due to that money demand rises then larger value of k will lead to larger increase in money demand due to which there is larger increase in interest rate that restricts growth in investment demand and therefore restricts growth.

Therefore, higher 'k' leads to weaker Transmission Mechanism.

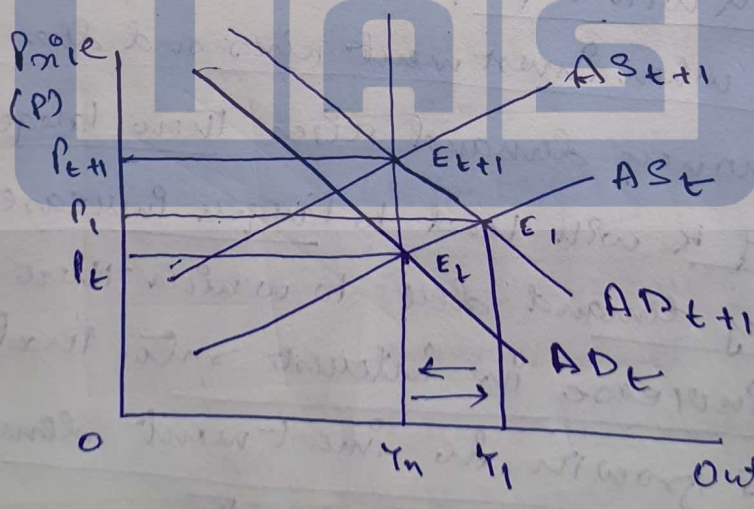
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Q1 d) How does Policy Ineffectiveness Proposition works if fooling model is applied into it?

→ In Policy Ineffectiveness Proposition, according to Rational expectational model, ~~any~~ any predictable or anticipated change in the policy will have no impact on output or other real variables in the economy.

However, according to Lucas, if the change is unanticipated then the output will increase in short-run and price will increase but not by the entire extent of increase in money supply.



Output increases from Y_n to Y_1 and price increases from P_t to P_1 because the workers

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assume that their real wage has gone up and they are fooled in the short run as they do not anticipate an increase in money supply.

However immediately at the end of time period 't', the workers realised that money supply has increased and AS curve shift upwards and price rises to cancel all increase in money supply. Output comes back to Yn.

Therefore, if fooling model is applied into Policy Ineffective Proposition, due to the unanticipated change in money supply, Output will increase in short run * and price with increase.

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01/e) Explain the objectives of public expenditure.

→ Public expenditure refers to the expenditure made by government such that there is management of economy. It has 4 main objectives :—

① Allocation of Resources (Efficiency) →

It refers to government providing subsidies for development of industries in backward regions to create balanced regional growth. It includes expenditure like production linked incentives to promote specific industries and expenditure on public investments.

② Distribution of resources (inclusion) →

Government expenditure on developing public utilities like electricity generation units, water supply, maintenance and development of sanitation ~~facilities~~ facilities, developing connectivity to backward region, expenditure on education provisions, expenditure on health care, poverty alleviation etc.

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(3) Developmental role → The role of public expenditure in improving capability of an economy through infrastructural development, promotion of public administration, implementing legislations and using them for contract enforcement etc refers to developmental role.

(4) Stabilization objective → Public expenditure can be used for stabilizing macroeconomic fundamentals of an economy. It also stabilizes the economy by reducing inflation and current account deficit by improving production capacity on supply side.

~~Microeconomic~~ Macroeconomic stability is also attained by consolidating public expenditure.

Thus the role of government in managing public expenditure has many objectives to ensure ~~stability and~~ growth and stability in the economy.

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Q2. a) Critically examine and compare monetary targets. Do you think inflation targeting is suitable for developing countries.

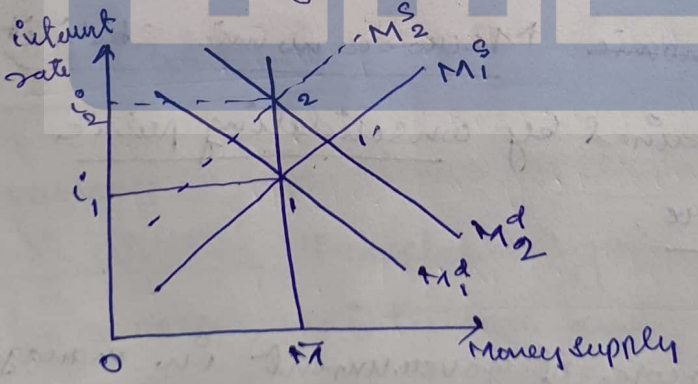
→ The monetary targets can be classified into:

(1) Intermediate target → a) Money Supply
b) Interest rate

(2) Final target → inflation.

Money Supply Target

Here, the quantity of money in the economy is fixed. The policies are designed such that money is fixed at $\bar{M}$.



It was easy to manage business cycles. If there is ~~fall~~ rise in consumption and M^d ~~falls~~ rise from M^d_1 to M^d_2 Then in order

to keep the quantity of money fixed, money supply will ~~increase to~~ decrease to M^s_2 and interest rate will rise from i_1 to i_2. Thus investment falls. However it can be a tricky concept in macro economic stability.

Interest rate targeting.

In case of interest rate targetting, response to increase in money demand will lead to increase in money supply to keep interest rate constant.

Taylor's rule for monitoring the adjustment is given by:

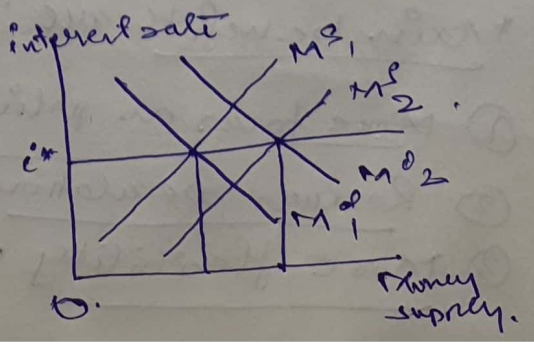
$$i^* = i - b[\pi - \pi^*] + a[y - y^*]$$

- i^* → targeted interest rate
- i → market interest rate
- $[\pi - \pi^*]$ → change in steady state inflation
- $[y - y^*]$ → change in full employment output.

There are two benefits of interest-rate targeting:

(1) It reduces fluctuations in real market

(2) It eliminates price fluctuation as change in money demand are observed by money supply.



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However,

(1) Any change in demand due to factors other than interest rate cannot be controlled.

(2) Political agreements will be difficult.

Inflation targeting.

In inflation targeting, there are 3 policies:

1) Accomodative Policy → Here interest rate will be determined to accomodate higher liquidity needed for growth. It is also called Dovish Policy.

(2) Neutral Policy → Here, liquidity is set to neutral among growth and inflation.

(3) Restricting Policy → Here, liquidity will be reduced to restrict inflation even if it results in compromising growth. It is also called Hawkish Policy.

Main benefits are:

(1) More focus on policy objectives.

(2) Reduces speculation

(3) More flexibility in choosing policy tools.

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Challenges:

(1) Inflation can be from supply side and monetary policy solely could not control it.

(2) May result in sterilisation

(3) May result in conflict with growth.

Therefore, it is not a bad idea to target inflation but institutional mechanism should be present to make sure debt management is done by independent institution and to make sure fiscal and monetary policy coordination is done together.

Also, transmission mechanism must be strong.

~~Therefor~~

Hence, inflation targetting may be suitable for dveloping country only if there is proper institutional mechanism and strong transmission mechanism. Otherwise it may not be suitable and can cause sterilisation and conflict with growth.

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Q2
5). Explain the differences between Classical and Keynesian Theory of AS.

→ The classical and keynesian theory of AS differs in various aspect. They can be categorised as following:

Classical AS	Keynesian AS
① Assumptions	① Assumptions
• There is wage price flexibility	• There is wage price rigidity.
• Supply creates its own demand, Thus economy is always at full employment.	• It is possible to have under employment
• Classical Dichotomy	• Short run analysis
• Perfect competition	• Demand side variables are important
	• Investment is autonomous of income and interest rate
	• Savings is affected by output or income.

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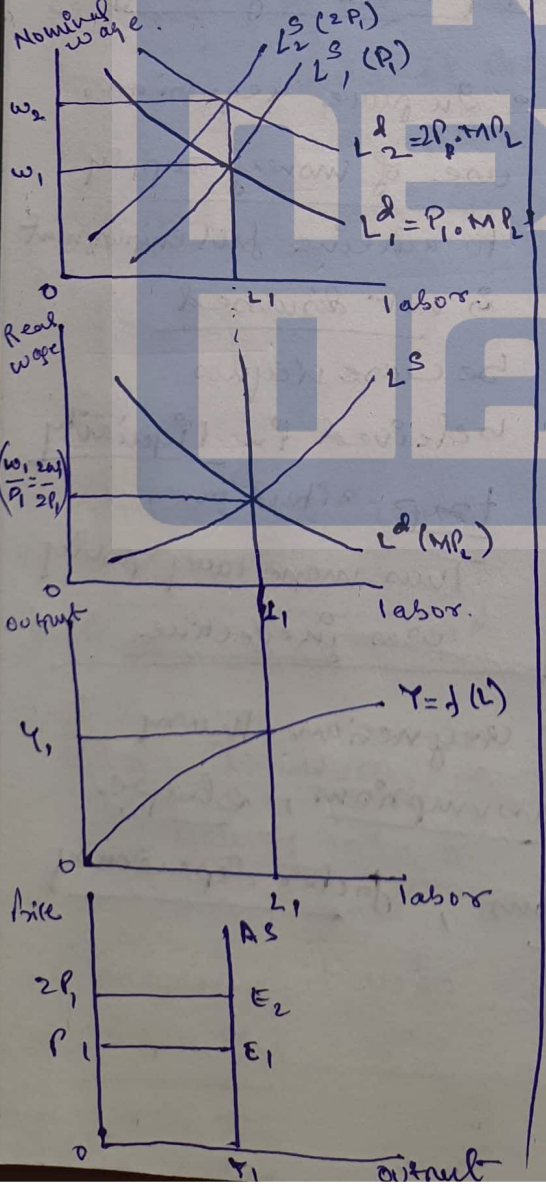
Classical AS

① Derivation.

Since there is wage price flexibility, real wage do not change.

Thus employment do not change and output do not change.

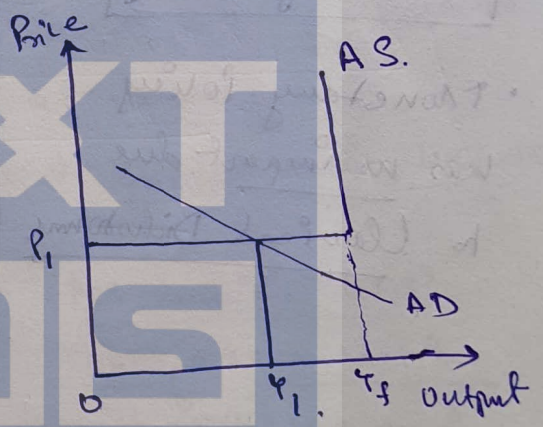
Thus AS is vertical.



Keynesian AS

② Derivation

There is wage price rigidity. Thus there is downward wage rigidity due to money illusion. A.S. curve of Keynes will be horizontal till full employment.



where Y_f = full employment output level.

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Classical AS	Keynesian AS
③ **Fiscal Policy** • Fiscal Policy is ineffective in classical model as classical model is a supply side model and it is only dependent on labor market.	③ **Fiscal Policy** • Keynes suggested that an expansionary fiscal policy could be used to make the economy increase AD and reach full equilibrium at the given price.
④ **Monetary Policy** • Monetary policy has no impact due to Classical Dichotomy.	④ **Monetary Policy** • In pure keynesian, use of money supply to achieve full employment is not discussed because Keynes believed in liquidity trap situation. Thus monetary policy was ineffective.

Therefore, classical and keynesian theory of AS differs due to assumptions, shape of AS, policy implications, factor dependency etc.

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Q2 c)

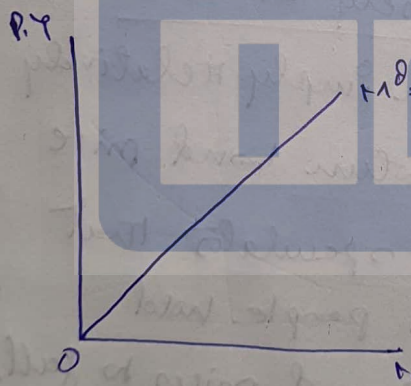
Examine ~~the~~ how Keynesian theory of money demand, improved over Cambridge.

→ According to Cambridge's Cash Balance Theory, money demand is given by

$$M^d = K \cdot P \cdot Y$$

where K = constant, representing the fraction of nominal GDP held in terms of money.

According to the theory, there is linear relation between nominal GDP and money demand under the assumption that money is demanded mainly for transactional purpose.



As nominal GDP rises, transaction will increase and money demand will rise in constant proportion.

~~Also,~~ However, K was not defined rigorously i.e. factors affecting K were not mentioned. Also, 'K' was volatile because it was affected by animal spirits.

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According to Keynes, there is a clear role of rate of interest with formal impact on money demand. He identified it by using speculative demand of money.

Thus, money is demanded for 3 purposes:

1. Transaction Demand
2. Precautionary Demand
3. Speculative Demand → based on interest rate.

→ Based on income level

According to his theory, interest rate and bond price are inversely related. A high bond price will imply relatively lesser interest rate but when bond price ~~falls~~ is high, market speculates that it will fall in future and people hold currency waiting for bond prices to fall.

He ~~defin~~ explained the Liquidity trap during Great Depression using this theory.

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Thus we can see that Keynes theory of money demand is improved over Cambridge because:

1) It included speculative demand for money

2) There is no proper definition of 'k' in cambridge.

3) There is no recognization of financial assets in Cambridge's theory.

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Q3 a) Examine the impact of behavioural and policy coefficients on money multiplier, highlighting what happens if they change.

→ Money Multiplier is the constant which shows the rate of extra creation of money supply due to a given increase in high powered money i.e. the money base created by central Bank.

Money Multiplier can be given as

$$m = \frac{c + 1 + t}{c + r(1 + t)}$$

where m = money multiplier

c = currency deposit ratio

r = required reserve ratio.

t = time deposit to demand deposit ratio.

It can also be derived by taking sum of currency multiplier and deposit multiplier and can be written as

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$$m = \frac{1+c^d}{c^d+r+e}$$

where c^d = currency deposit ratio.

e = excess reserve ratio.

Here, c^d and e are behavioural coefficients while r is policy coefficient.

Impact of Behavioural coefficients.

They are determined by banking system, households and firms in the economy.

'e' is determined by 1) interest rate (inverse relation)

2) risk of deposit-withdrawal (positive relation)

3) non performing assets (positive relation)

4) cost of borrowing of banks (positive relation)

Therefore if 'e' is increased then 'm' decreases and if 'e' is decreased, 'm' increases. Thus there is inverse relation between 'e' and 'm'.

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c^d depends on several factor like:

1) interest rate (inverse relation)
2) fee on withdrawal deposit (direct relation)
3) probability of banking failure (direct relation)

Therefore, there is inverse relation between c^d and m.

High 'c^d' leads to low 'm' and low 'c^d' leads to high 'm'.

Impact of policy coefficient.

'γ' is a policy determined ratio and after considering long term value of 'c' and 't', monetary authority chooses a suitable 'γ' to assure high powered money is changed in correct proportion to match expected increase in money demand.

'γ' has inverse relation with 'm'.

An increase in 'γ' leads to lower money multiplier and vice versa.

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Q3 b) Each firm has an incentive to cheat the other in a duopoly model of collusion. Explain.

→ To understand the incentive of each firm to cheat in a duopoly model of collusion, first we look at:

Case I:

Pure Bertrand model: Here 2 firms sell homogenous goods and there is simultaneous price setting by both the firms. Marginal cost is fixed for both firms. Ideally the firms should choose monopoly price & maximize their profit however firms do not have any credible reason to believe that collusion in the market will be maintained.

Thus firms use backward induction ~~technique~~ to formulate their best strategy and it comes out to be charged $P = MC$ in order to avoid potential loss from due to deviation by other firm. Therefore they reaches a solution of perfect competition

This is called Bertrand Paradox.

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Case II. Cournot Duopoly.

Here, only 2 firms with homogenous goods compete by simultaneous quantity setting. None of the firms know with surity regarding decision taken by other firm.

If market demand is given by $P = 100 - Q$ and Marginal cost : $MC = 4$. Then,

Profit of firm 1, $\pi_1 = P \cdot q_1 - C \cdot q_1$

$= (100 - q_1 - q_2) q_1 - 4q_1$

$\frac{\partial \pi_1}{\partial q_1} = 100 - 2q_1 - q_2 - 4 = 0.$

$\therefore$ Best Response of firm 1 =

$$\boxed{q_1 = \frac{96 - q_2}{2}} - (1).$$

Similarly Best response of firm 2 is

$$\boxed{q_2 = \frac{96 - q_1}{2}} - (2).$$

Solving for q_1 and q_2 we get

$$q_1 = \frac{96 - \left(\frac{96 - q_1}{2}\right)}{2}$$

$$q_1 = 48 - 24 + \frac{q_1}{4}$$

$$\therefore \boxed{q_1^* = 32 = q_2^*}.$$

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Thus if there is no collusion then,

$P^* = 100 - Q = 36.$

And $\boxed{\pi_1^* = \pi_2^* = 1024.}$

If there is collusion then,

$\pi = TR - TC$

$= Q(100 - Q)Q - 4Q.$

$= 96Q - Q^2.$

$\frac{d\pi}{dQ} = 96 - 2Q = 0.$

$\therefore Q = 48 \begin{cases} q_1 = 24 \\ q_2 = 24. \end{cases}$

$P^* = 100 - 48 = 52.$

$\pi^* = 2304 \begin{cases} \pi_1^* = 1152 \\ \pi_2^* = 1152. \end{cases}$

If any firm chooses to collude but other firm cheats then,

Collusion output is $24 = q_1 = q_2.$

Best Response of firm 1 $= \frac{96 - q_2}{2} = q_1$

Best Response of firm 2 $= \frac{96 - q_1}{2} = q_2.$

Thus any firm can maximize profit if it produces $q_i = \frac{96 - 24}{2} = 36.$

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and the other firm will produce

$q_j = 24$.

Thus profit of firm 'i' which cheats (competes)

$\pi_i = P \cdot q_i - c q_i$

Now $P = 100 - Q = 100 - (36+24) = 40$.

Thus $\pi_i^c = 40 \cdot 36 - 4 \cdot 36 = \boxed{1296}$.

while $\pi_j^c = 40 \cdot 24 - 4 \cdot 24 = \boxed{864}$.

where firm i cheats and firm j colludes.

So,

firm 2

firm 1	Compete	Collude
Compete	1024, 1024	1296, 864
Collude	864, 1296	1152, 1152

Here we see that the dominant strategy of both firm is to compete.

∴ Since Nash strategies are (Compete, compete), thus we can say each firm has an incentive to cheat the other in a duopoly model.

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Q3 (c) Derive the expansion path of a firm when Labour and capital are perfect complements and perfect substitutes.

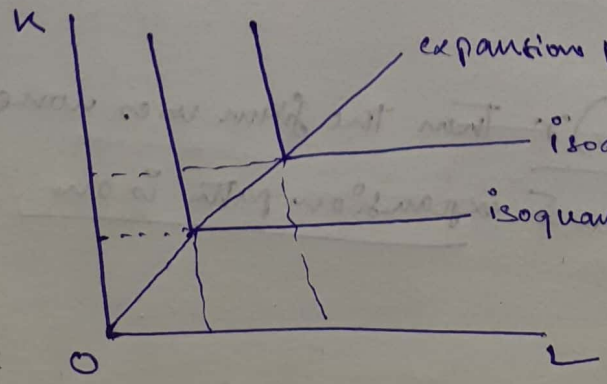
→ Expansion path represents combination of equilibrium points of a firm at different levels of expenditure.

It represents all points where

$$MRTS_{L,K} = \frac{w}{r}$$ where w = wage, r = rent

When labour and capital are perfect complements then, production function can be represented by $Q = \min(\alpha L, \beta K)$. for some constants α & β. and L represents labour while K represents capital.

Given the shape of its isoquants, the output expansion path of this production function is a ray from the origin.



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With perfect complements, equilibrium will be when

$$\alpha L = \beta K.$$

$$\Rightarrow \boxed{L = \frac{\beta}{\alpha} K} \quad \text{or} \quad \boxed{K = \frac{\alpha}{\beta} L}$$

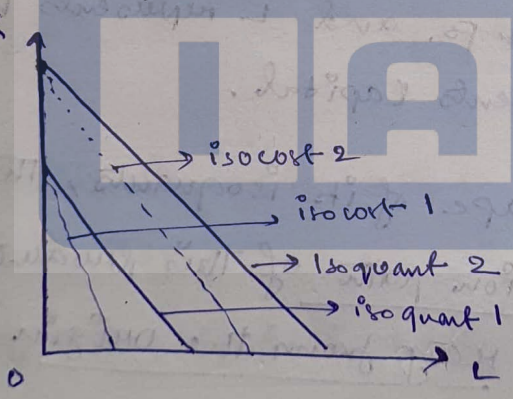
Thus expansion path is the line $\boxed{K = \frac{\alpha}{\beta} L}$

When labour and capital are perfect substitute, the production function can be written as

~~$Q = \alpha K$~~ $\boxed{Q = \alpha L + \beta K.}$

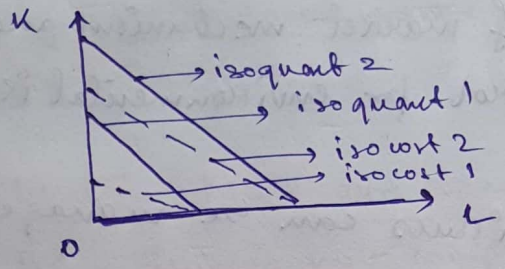
Here, there are 3 cases:

1) If $w > (\alpha/\beta) r$ then the firm uses none of labour and the expansion path is on K axis.



2) If $w < (\alpha/\beta) r$ then the firm uses none of capital and expansion path is on L-axis.

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3) If $w = (\alpha/\beta)\,r$, every combination of labour and capital is optimal and there is not a single output expansion path.

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Q5. 9). Examine the role of market mechanism and command and control for environmental issues.

→ Environmental issues can be managed through:

1) Market Mechanism (MBI)
2) Command and control (CAC)

Market Mechanism.

→ In these mechanism, instruments are used to equalise Marginal Benefit to Marginal cost to achieve efficiency distance.

→ These includes Pigouvian tax and Coasian Bargain which are neoclassical corrections

→ The direct instruments are emission fees and marketable permits.

Command and control

These are authoritative directions directives by the government in the

form of emission taxes, controls, ban on certain equipments etc.

In literature, MBI are traditionally opposed to CAC. This is not completely true because success of MBI depends on well functioning of CAC.

→ MBI and CAC complements each other because real market place is heterogenous, asymmetrically informed and for successful implementation of MBI, initial presence of CAC is required.

→ In MBI, the challenge is to set the tax rate in such a way it discourages pollution without compromising efficiency of production. Here, giving initial investment subsidies to shift to a cleaner technology can play a positive role.

Thus, MBI are more significant when there is higher presence of CAC as monitoring environmental performance and enforcing compliance are crucial for success of policy.

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Q3
5) Do you agree that the Ricardian legacy is inherent in the Lewis Model of Economic Development.

→ In Lewis Model, he makes the following assumptions:

→ The economy has dualism — Rural agriculture Based sector
— Urban Capitalist system

→ Supply of labours in subsistence sector (rural) is greater than demand which causes surplus labour.

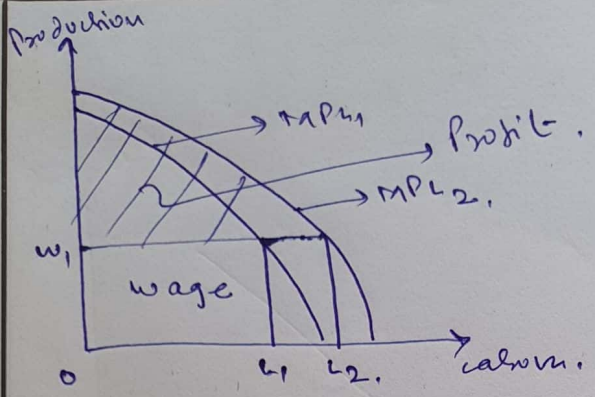
→ Diminishing return to labour in both sectors.

→ He differentiated between labour and labourer and defined surplus labour not labourer.

According to Lewis, when MP_2 is below subsistence wage (w), workers are qualified as disguised unemployment.

Industrial sector can absorb all these surplus labour by offering slightly higher wage rate $W_1 > W$.

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Lewis explained that real impetus to grow is capitalist surplus; which keeps increasing as capitalists re-invest their profits and expand modern sector.

Ricardian theory is inherited in Lewis Model as he used the theory of labour value given by Ricardo in defining surplus labour (productivity).

Therefore while explaining rural urban migration in his model, Ricardian theory was inherited to explain rise in productivity of labour.

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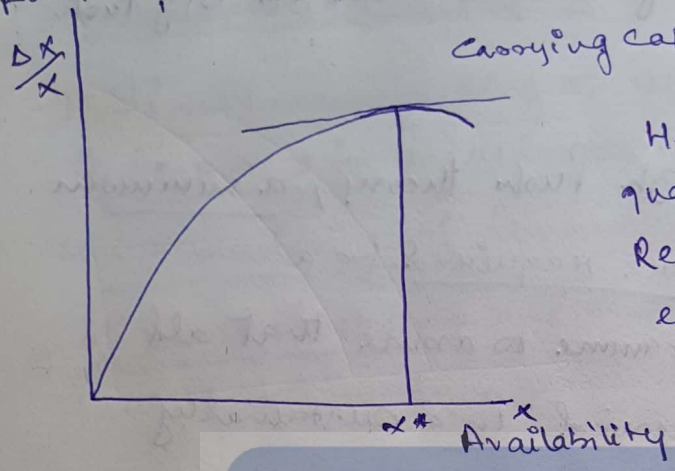
Q5 c) Examine Meade's model of sustainability. What is the importance of carrying capacity in it?

→ According to Meade's model of sustainability, renewable resources can be harnessed in such a way that it is possible to reach an optimum rate of harvest without any loss of Natural resources. They called this natural carrying capacity of the environment.

According to the theory, the environmental model should consider the benefits of extraction compared to loss of immediate use which reduces the value of stock from growing larger in future. If addition to stock has higher returns as compared to its immediate use, it is suggested that conservation for the future is a better solution for immediate utility. This is reached when rate of return is zero.

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Rate of change in availability.



Carrying capacity of a species.

Here, x* is maximum quantity of Natural Resource that can be extracted when carrying capacity Reaches 0.

The Marginal Product of stock should be compared to the rate of discount in its future value if it is utilized today. As long as Marginal Product gains capital gains in stock value is higher than cost of discounting the stock, it should be assured that the species harvest is not disturbed.

Also, for non renewable & exhaustible resource, optimum depletion should be established such that social value is optimized and inter generational equity is maintained.

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Q5 d). What is the role of indivisibilities in Big Push Theory?

→ According to Bigh Push theory, a minimum level of resources are required for a development programme to assure that all obstacles are removed in a sustainasy high level of growth for the economy.

There are 3 kind of indivisibilities in the theory.

① Indivisibilities in the Production Function

→ Indivisibilities of inputs, outputs or processes lead to increasing returns.

→ Social Overhead Capital is regarded as most important indivisibility.

→ They cannot be imported

→ Their installation require huge investment.

Thus, an Initial high investment in SOC is necessary.

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② Indivisibility of Demand.

→ Simultaneous setting up of independent industries in underdeveloped country so that complementarity of demand could reduce risk of market absence and keep incentives to invest continuously.

③ Indivisibility in supply of savings

→ An increase in investment will require high volume of savings which is not easy to achieve in underdeveloped economy.

→ Thus big push to save to have minimum quantity of investment in SOC is required.

Therefore all the three indivisibilities are required ~~to solve and complete~~ for a sustainable development.

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Q5 e) Explain the distortionary effects in an export subsidy.

→ Export Subsidy implies a possibility for domestic sellers to sell at a relatively higher price in domestic market without increasing their price in foreign market.

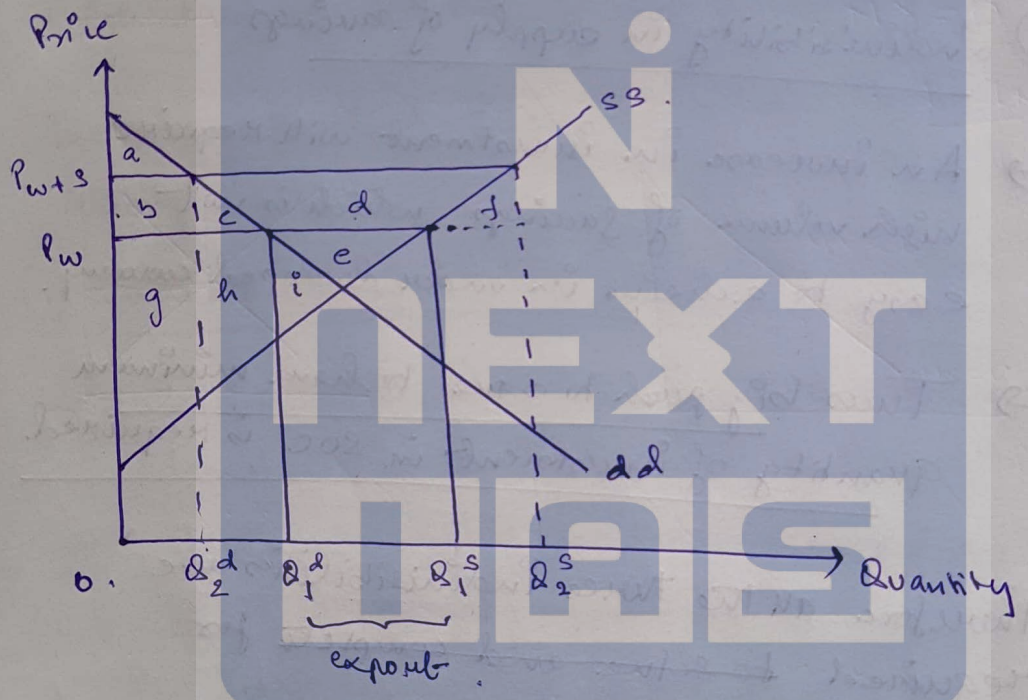


Fig: Domestic Market with export-subsidy

To see the distortionary effect in an export subsidy, first compare the surplus.

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Before Subsidy,

Consumer Surplus = a+b+c

Producer surplus = g+h+i+e.

Total Surplus = a+b+c+g+h+i

After Subsidy,

Consumer Surplus = a

Producer Surplus = b+c+d+g+h+i+e.

Expenditure by government = c+d+f.

Total Surplus = a+b+g+h+i+e-f.

Therefore difference in surplus = c+f.

Here c is the consumption distortion.

Consumer surplus decreases because exporter will not be willing to sell at a lesser price.

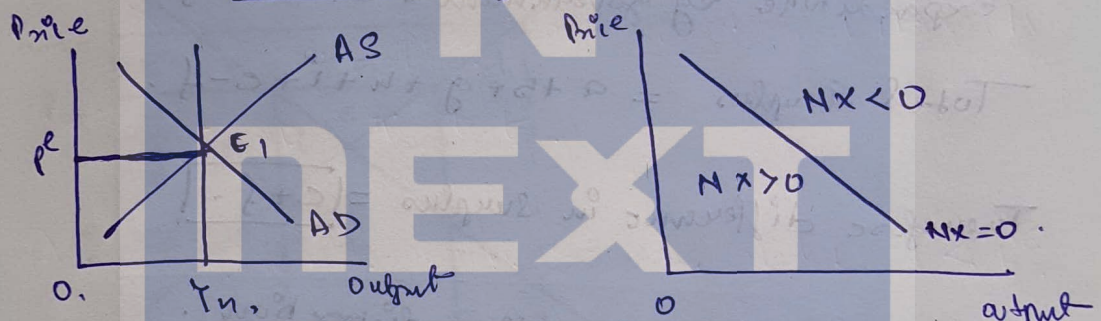
f is the production distortion

Producer surplus increases but on a net basis to the economy due to extra welfare loss borne by government. Therefore loss of welfare is unambiguous and there is no gain in welfare

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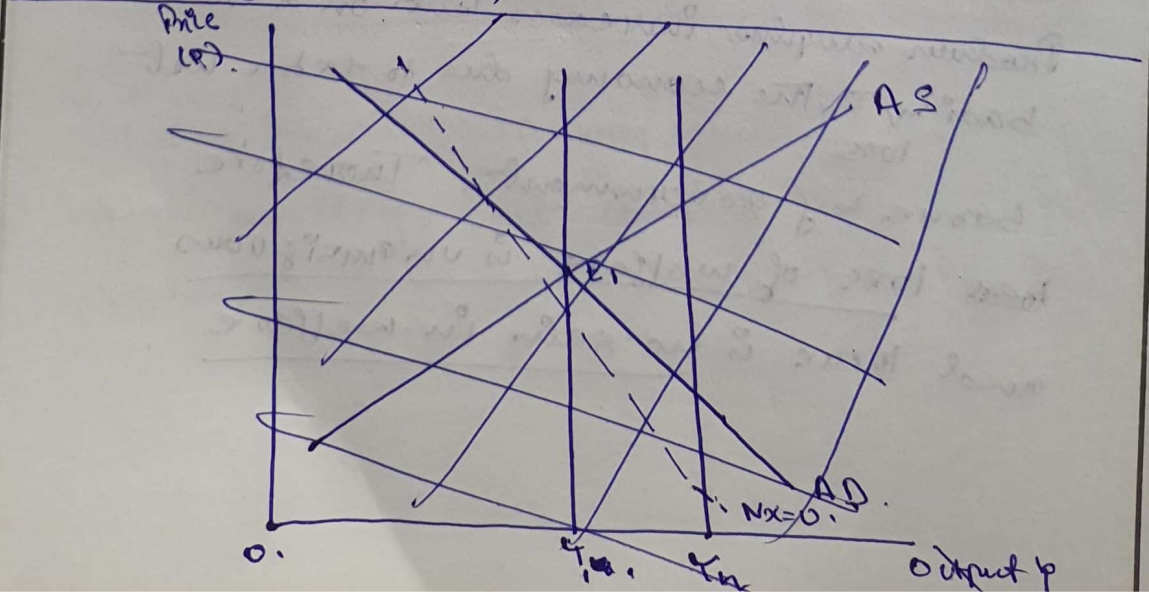
Q7. a). Explain how in fixed exchange rate and no capital mobility the economy makes automatic adjustments from deficit and unemployment. How can policy making improve it?

→. In automatic adjustment mechanism, with fixed exchange rate and no capital mobility, external balance takes place when $NX = 0$ and internal balance takes place when $Y = Y_N$.



(Internal Balance). (External Balance)

When the economy has trade deficit and unemployment- then,

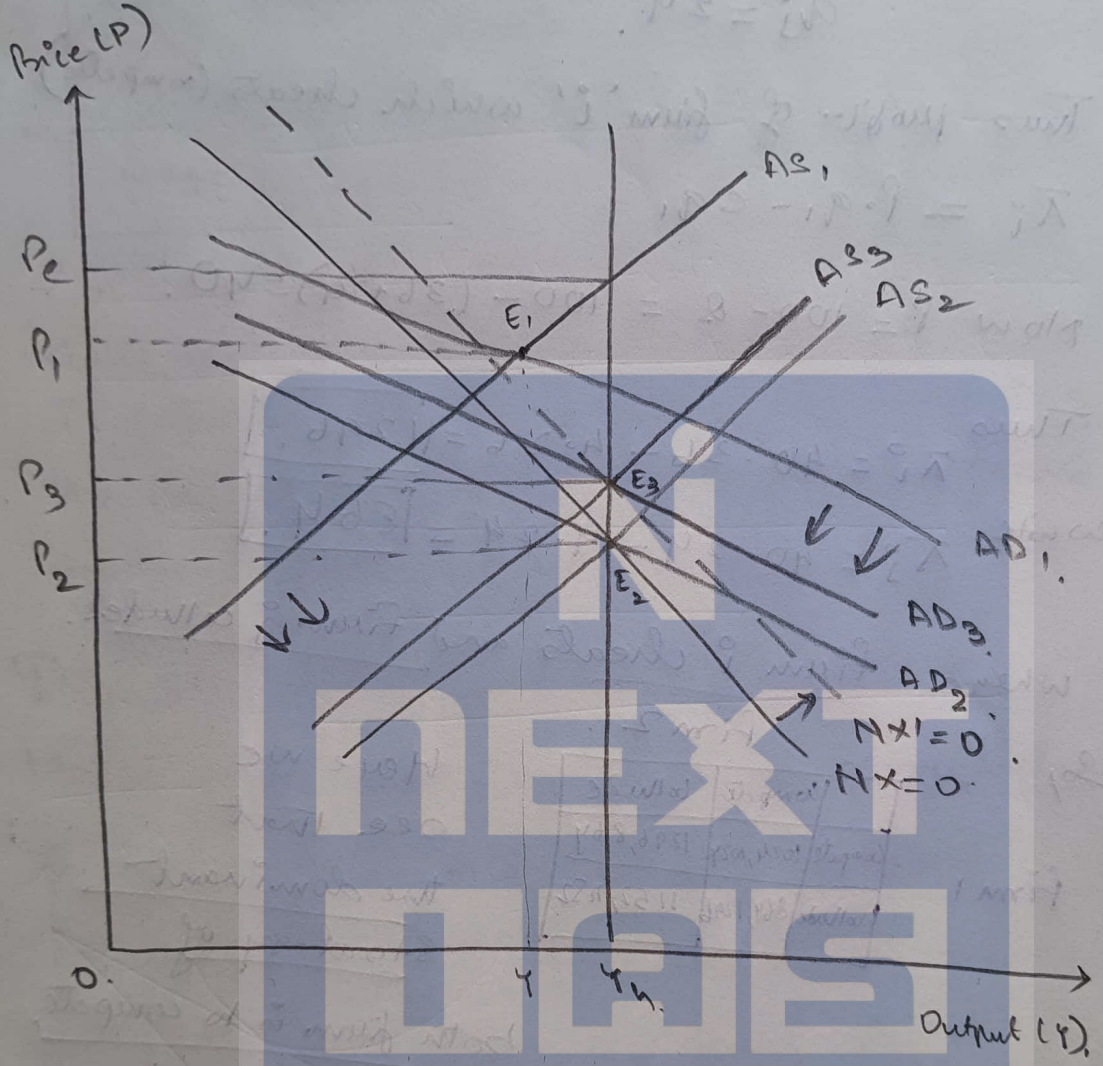


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At E_1, $y < y_n$ i.e. unemployment and $NX < 0$ i.e. trade deficit as E_1 is above $NX = 0$

So,

a) Trade deficit will lead to pressure to devalue the currency.

b) Central Bank intervenes by buying domestic currency and selling foreign exchange in the market.

c) Money supply is reduced and it will shift AD to the left.

AS curve shifts down because at E_1, $P < P^e$. AD and AS keep shifting ~~towards~~ downwards till point E_2 is reached where $Y = Y_n$ and $NX = 0$. This implies that economy can revert to a new equilibrium without any government intervention. However, it has been observed that the economy will take a lot of time in with persistent recession and deflation. This can lead to depression in the economy.

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Therefore, policy resolution through 'expenditure switching' and 'expenditure reducing' policy is suggested to bring faster resolution with lesser deflation.

① If the government devalues the currency (expenditure switching) then net export rises and NX=0 line shifts to the right. If nothing else is done then this will shift AD to the right and it will cancel entire nominal devaluation.

② Therefore government also implements expenditure reducing policy i.e. contractionary monetary or fiscal policy. It assures that AD shifts down inspite of rightward shift in NX. This continues along with downward shift of AS till E_3 is reached where price falls by a lesser value and output reaches Y_n at a faster rate.

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Q7 b) Comment on how asset bubbles are formed and policy responses to it.

→ The term bubble in an economic context generally refers to a situation where price for something - an individual stock, a financial asset or even an entire sector, market or asset class exceeds its fundamental value by large margin.

To understand how asset bubbles are formed, the following stages outline the pattern.

1) Displacement → It occurs when investors get enamored by a new paradigm as an innovative new technology or interest rate. The most common cause is easy money policy.

2) Boom → Price rises slowly at first but then gain momentum as more and more participants enter the market. This leads to more speculation.

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3) Euphoria → During this phase, caution is thrown to the wind and the greater fool theory plays out everywhere.

4) Profit-taking → In this phase, smart money starts selling positions and taking profits. This means heeding the warning sign that bubble is about at its bursting point, they start selling the assets.

5) Panic → It only takes a minor event to prick a bubble, but once it is pricked, the bubble cannot inflate again. In this stage, asset prices reverse course and descend as rapidly as they had ascended.

One of the most vivid examples of global panic was in Oct 2008, after Lehman Brothers declared bankruptcy.

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Policy response to control asset bubbles can be:

1) Monetary Policy → Government can exercise contractionary monetary policy to curb in liquidity i.e. excess liquidity

2) Structural Reforms → For long term control of asset bubble formation focus should be on

a) Regulations to ensure fixing market failures

b) Regulation should be designed so as not to exacerbate the interaction between price bubbles and credit creation.

c) Regulatory policies should be focused on soundness of individual institutions.

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Q7 c)

What are the main achievements of COP26?

→ The Glasgow Summit also known as COP26 had to ~~the~~ deal with disturbing prospect that the world was set to reach nearly +3°C by the end of century, above the Paris Agreement target of well below 2°C and ideally 1.5°C above the industrial levels.

The main achievements of COP 26 are:

① New Global and Country Target-

The Summit has urged countries to consider strengthening their targets by COP27.

The Summit targeted global warming not to exceed +1.5°C and got about 140 countries to announce target dates for bringing down emission to net zero.

India has also joined the consensus and announced its net zero target of 2070.

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(2) Glasgow Breakthrough Agenda :

The Glasgow ~~Breakg~~ Breakthrough Agenda which was endorsed by 42 countries including India is a cooperative effort to accelerate the development ~~and dev~~ and development of clean technologies and sustainable solutions in areas such as clean power, road transport, etc.

(3) Phasing Down Coal Consumption :

A middle path as suggested by India was referred ~~to~~ to at COP 26 calling for a phase down of coal based power.

(4) Best Case Scenario : An early assessment by Climate Action Tracker suggest that the targets declared, if fully achieved could limit global warming to around +1.8°C.

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However there were some setbacks of the meeting like: a) Voluntary targets

b) Lack of Specific Details and Actions

c) Failure in Securing Climate Finance

d) Unequal distribution of Carbon Budget.

The COP26 of Glasgow is a promising start on emission reduction, however, on part of global largest emitter, much more is expected to be done.

NEXT IAS

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