mssharma5523@gmail.com

Attempted – 1, 4, 5, 6, 7

NEXT IAS

(To be filled by candidate)

Name of Candidate : Manish Sharma

Roll No. : .....

Registration Number : NIAS23 00020264 Date of Examination : 29 Aug

Exam Centre : Old Rajinder Nagar ☐ Bhopal ☐ Online ☑

CSE (MAINS) TEST SERIES - 2023

Test-07	ECONOMICS OPTIONAL
Dated : 27-08-2023	*Full Syllabus (Paper-I)*

Time Allowed : Three Hours | Maximum Marks: 250

QUESTION PAPER SPECIFIC INSTRUCTIONS

(Please read each of the following instructions carefully before attempting questions)

*There are **EIGHT** questions divided in **Two sections** and printed in **ENGLISH**.*

*Candidate has to attempt **FIVE** questions in all.*

***Question No. 1 and 5** are compulsory and out of the remaining, any **THREE** are to be attempted choosing at least **ONE** question from each section.*

The number of marks carried by a question/part is indicated against it.

Answers must be written in the medium authorized in the Admission. Certificate which must be stated clearly on the cover of this Question-cum- Answer (QCA). Booklet in the space provided.

No marks will be given for answers written in a medium other than the authorized one.

Word limit in questions, wherever specified, should be adhered to.

Attempts of question shall be counted in sequential order. Unless struck off. Attempt of a question shall be counted even if attempted partly. Any page or portion of the page left blank in the Question cum Answer (QCA). Booklet must be clearly struck off.

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(For filling by Examiners only)

Q. No.	Page No.	Max. Marks	Marks	Total	Signature
1. (a)	4	10			
1. (b)	6	10			
1. (c)	8	10			
1. (d)	10	10			
1. (e)	12	10			
2. (a)	14	20			
2. (b)	18	15			
2. (c)	21	15			
3. (a)	24	10			
3. (b)	26	20			
3. (c)	30	20			
4. (a)	34	20			
4. (b)	38	15			
4. (c)	41	15			
5. (a)	44	10			
5. (b)	46	10			
5. (c)	48	10			
5. (d)	50	10			
5. (e)	52	10			
6. (a)	54	15			
6. (b)	57	20			
6. (c)	61	15			
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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SECTION-A

Write notes on the following in about 150 words each: (10 × 5 = 50)

Q.1 (a) Use IS LM model to explain trade as an engine of growth.

Trade as an engine of growth reflects its role in economic development through:-

→ rising exports
→ more efficiency and competitiveness
→ Achieving economies of scale
→ Building comparative advantage

The impact of trade can be seen through IS-LM analysis

Case 1 : flexible exchange and open small economy

* Here monetary policy can be used to give filip to exports

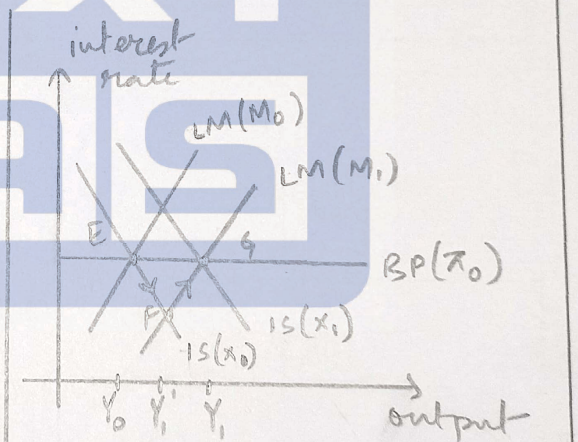


Fig: Monetary policy & trade

* $M_0 \rightarrow M_1$ results in depreciation leading to rise in exports from $X_0 \rightarrow X_1$ and output from $Y_0 \rightarrow Y_1$ (instead of just Y_1')

→ This is widely observed in Western European nations of Switzerland, Denmark who

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through open economy. achieved rapid growth

Case II: Fixed exchange rate and good capital mobility

* Here a fiscal push helps attract huge capital inflow

∴ output rises from $Y_0 \rightarrow Y_1$

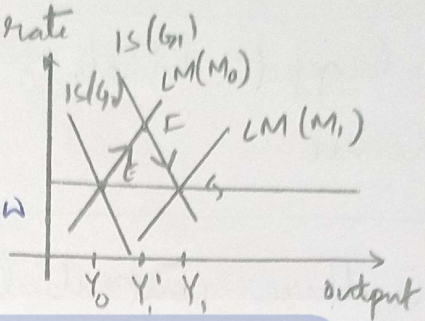


Fig. fiscal incentive and trade

Case III: Import substitution trade

* Through import sub. practices, a nation reduces imports

* Hence, any further govt intervention (Money $M_0 \rightarrow M_1$) results in output increase from $Y_0 \rightarrow Y_1$ rather than just $Y_0 \rightarrow Y_1'$

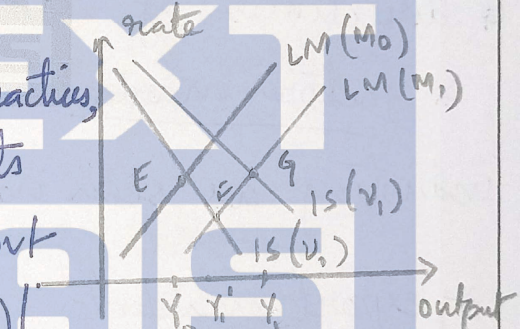


Fig: Trade & change in multiplier import $V_0 \gtrless V_1$

Hence, trade as an engine has been crucial focus of new Foreign Trade Policy with aim of $2 trillion exports by 2030.

Q.1 (b) "Agriculture contributes to development and also gets contributed to by it". Discuss.

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The resilience of agriculture and its contribution to growth helped tackle the biggest black swan event - the covid pandemic

---

Agriculture contribution to development

→ Consist of 16% of gdp and 46% of direct employment

→ 4 directions of contribution :-

* factor market - supplies labor to industry as seen in lewis model

* export market - - $60 billion in 2021-22, high value addition in vegetable, horticulture

* Demand for industrial goods - 40% informal sector as farmers ⇒ fmcg, tractor, equipments

→ Brings equitable growth - green revolution

→ Tackling climate change - 18% GHG contribution

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Development contribution to agriculture

→ Myrdal's spread effect ⇒ rising demand for agri goods in urban areas

→ food processing sector : rising farmer income, tech improvement through contract farming

→ Increased productivity ⇒ higher wages due to ~~organic~~ new tech - SRI

→ Krishi Vigyan Kendra, ISRO satellites for weather prediction ⇒ improved farming

→ Thrust on sustainable farming - PM Pranam mission, zero budget natural farming

Hence, development and agriculture have developed a dichotomous relationship. ~~and~~

Q.1 (c) Explain the differences between Kaldor's and Kalecki's model of distribution.

Kaldor and Kalecki models try to explain the distribution of factors of production - wages, profits etc in the economy

Kaldor's model	Kalecki's model
→ Based on Keynesian analysis of economy	→ Uses monopoly power of firms in determining distribution
→ All wages - salary, non-salary taken together - as workers	→ Salaried class wage taken under portion of firms. * Only laborer's wages taken as wages.
→ Key Assumptions * Savings = Investment * $S_p > S_w$ where S_p = mps of profits enterprises S_w = mps of workers	Key assumptions * MC = AC * monopoly power by lerner's index (μ)
→ Key Outcome $\frac{P}{Y} = \frac{1}{Y} \cdot \frac{I}{S_p - S_w} - \frac{S_w}{S_p - S_w}$ where P/Y is share of profits in Economy, I is investment	Key Outcome $\frac{W}{A} = \frac{1}{1 + \bar{\mu} \cdot \frac{T}{W}}$ where $\frac{W}{A}$ is share of labor $\bar{\mu}$ is overall monopoly, T is Turnover

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→ Hence, level of investment determine the share of profit and workers

→ Explained the rise of share of Profits during inflation -ary times and fall during recession

→ Assumptions are less restrictive

→ General equilib. analysis in nature

→ The level of overall monopoly power of firms and aggregate turnover decide ratio of worker wages

→ Explained why workers share has remained Constant since WW II

* $\bar{\Pi}$ increased
* Turnover decreased due to ↓ng raw material cost

→ Highly restrictive assumptions

* ignored power of union all together
* Treating salaried & non-salaried differently

Hence, Kaldor's analysis was an improvement over Kalecki's.

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Q.1 (d) "Monopoly power exists in all imperfect competition markets, only the degree is different." Do you agree?

Monopoly power of a firm refers to the power to influence pricing in the economy by a firm, in imperfect competitive market.

* This is in contrast to perfect competition where firms are price takers.

Monopoly power in all imperfect comp. markets

→ Monopoly :- Here the firm can set prices on its own in long run.

* OP price set by firm despite only QB as the marginal cost

* Earns supernormal profit

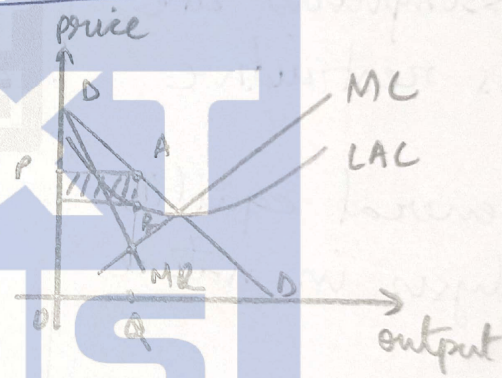


Fig 1: Monopoly

→ Monopolistic Competition

* even though firm set price OP and OP > QB (MC)

* No supernormal profit

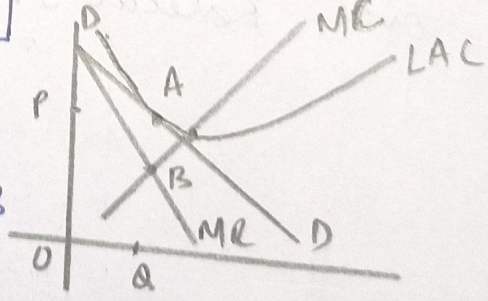


Fig 2: monopolistic competition

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→ **Oligopolies** → price leader can set up own price based on different parameters – lower average cost, joint max profit as in cartel, advertisement

* Can earn supernormal profit in long run.

Different degrees

→ High monopoly power degree since supernormal profit in monopoly (fig.)

* lerner's index =

→ Monopolistic competition : low monopoly power degree as no supernormal profit

* entry of other firms highly dictate price setting

→ Oligopoly : varying monopoly power ~~from due to~~ increase competition (telecom) to joint profit max (OPEC)

Hence, yes I agree that monopoly power exists in all but @ degree is different.

Q.1 (e) What is Tobin's q theory?

Candidates must not write on this margin

Tobin's q theory measures whether a firm or a aggregate market is over or under valued

$$\text{Tobin's } q = \frac{\text{Total Maket value of firm}}{\text{Total Assets of the firm}}$$

Hence, at a Q-ratio < 1

* means that cost to replace a firm's asset is greater than value of the stock. Hence, the stock is undervalued

* This suggests that company should increase its profit by selling some of its assets

* This will raise the stock price also

Also, at $Q > 1$

* stock is overvalued, hence company can sell stocks and builds assets for future growth.

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→ Hence value of 'q' acts as an investment signal.

At Q > 1 → go for investment.

Deficiencies

→ Olivier Blanchard – fundamentals such as profit rate much better to predict investment.

→ often failed in predicting outcomes

Hence, newer methods such as P/E ratio have come up to bring more focus on investment potential.

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Q.4 (a) How does per unit subsidy create dead weight loss? Do you think a direct subsidy is better? 20

Candidates must not write on this margin

Dead weight loss is the overall loss of welfare resulting due to economic and policy inefficiencies.

* disturbs optimum economic resource allocation, production or consumption

Subsidy and Dead weight loss

→ A subsidy is a tax rebate or incentive given to producer/consumer

* If a unit subsidy of AB is given ⇒ supply curve shifts from SS → SS'

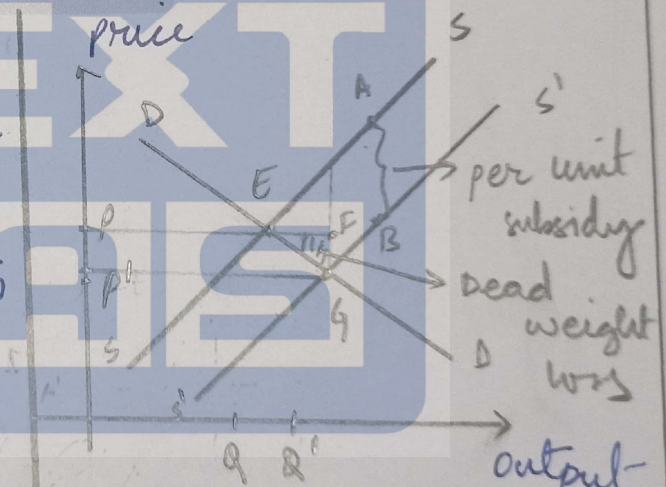


Fig: Dead weight loss due to unit subsidy

→ Hence, the equilib changes from E to G (OP, OQ) to (OP', OQ')

→ Total subsidy = PP'GF

→ Gain in welfare = PP'GE

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→ Hence, EFG is the dead weight loss due to unit subsidy.

Reasons

→ The subsidy for say product X, resulted in its extra consumption wrt other products say Y (no subsidy)

* Hence, there was distortion in overall consumption pattern ⇒ dead weight loss

Is direct subsidy better

→ In direct subsidy, direct monetary incentive is given, without any market-price distortion between products.

→ It results in better consumer welfare since consumer have more choices on how to spend ↑sed income

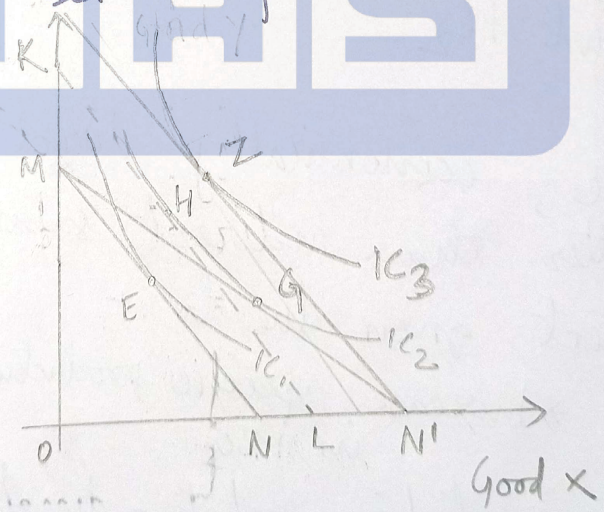


fig: Direct vs indirect subsidy

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→ In fig, the indirect subsidy shifts consumption curve from MN → MN' ($P_x \downarrow$ ses)

* This results in ↑se in welfare from $IC_1 \rightarrow IC_2$

→ However, through compensating variation, the same improvement would have been reached if Prices of both were changed keeping proportion same

* However the subsidy used would have been less NL as against NN'

→ Also, direct income subsidy of NN' would result in IC_3 indiff curve instead of just IC_2

Hence, economically direct subsidy is better than indirect subsidy. However indirect given due to :-

* Increase specific production - wheat, rice in 1960s
* inflation relief - diesel, petrol
* bring change in consumption pattern
  ↳ direct money used in buying alcohol

Candidates must not write on this margin

However, direct subsidy also has its issues :-

* It distorts leisure - income dynamics
* may result in less work

Hence, depending upon objective, cost-benefit, it should be decided which type of subsidy should be given

Q.4 (b) How will a monopoly reach equilibrium if government regulates pricing? 15

Candidates must not write on this margin

Monopoly refers to market condition where there is only one seller with closed entry to market and no substitutes of goods close. by monopolist.

Monopoly equilibrium

→ for a monopolist, at profit maximisation condition, MR = MC (in eq)

∴ OP is the eq. price with OQ output

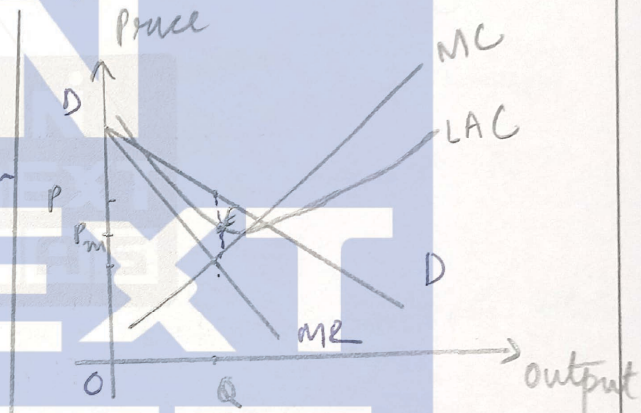


Fig: Monopolist equilibrium

Government regulating Pricing

→ If government sets price (P_g)

* This is similar to a profits tax on the monopolist provided $P_g > P_m$

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* Hence, though monopolist will experience a loss, his output remains same as OQ remains most optimum output

→ If $P_g < P_m$

⇒ impossible for monopolist to remain in market and hence closes in long run

If govt regulates by taxing at unit tax 't'

* Here the equilib. price and output changes because marginal cost shifts to left (MC → MC+t)



→ However the net rise in price EF < tax t imposed (EF < MN)

→ Hence, monopolist bears some portion of ↑se in tax t

* output ↓se from OQ_0 to OQ_1

as seen in fig.

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Hence, govt recently imposed various taxes - windfall to regulate monopoly pricing power.

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(c) Explain the concept of NAIRU. 15

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SECTION-B

Write notes on the following in about 150 words each: **(10 × 5 = 50)**

Q.5 (a) "Baumol and Keynes included interest rate as a factor affecting money demand, but treated it differently." Discuss.

Baumol and Keyne's both placed the importance of money and interest rate in determining output and consumption.

Baumol's treatment of interest rate

→ Baumol established that interest rate impacted transaction demand of money.

→ Used inventory management theory to explain optimum transaction demand

→ A person will try to maximise the interest earned on the requisite transaction demand.

* Also, cost of visiting bank, shoe leather cost also applicable

→ Hence, Transaction demand (C) ∝ Output (Y)

$C \propto \frac{1}{r}$ (interest rate)

→ Baumol predicted the optimal Demand as $\sqrt{\frac{2bY}{r}} = C$ where b is constant.

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Keynesian treatment of interest rate

→ According to Keynes, transaction demand (L) only depends on income (Y)

$L = L_0 + L_1 Y$ where L_0, L_1 are constant.

→ However, interest rate help in wealth management of individuals through impacting supply & demand for bonds.

→ Each individual has a critical rate (i_c) which is equilib. rate of economy.

* If prevailing rate $r > i_c$ ⇒ individual converts all his speculative money to bond

* if $r < i_c$ ⇒ potential for capital loss on bond ⇒ store all wealth in money (M_i)

→ Hence, speculative demand for money (M_i) is inversely proportional to interest rate

$M_i = -L_2 r$

Hence, Keynes and Baumol treated interest impact on economy differently.

Q.5 (b) What is the role of public expenditure in development?

Public expenditure is the fiscal expenditure by government which helps in economic development.

↳ Target of 10 lakh crore capital expenditure by union in 2023-24

e.g. - Food subsidy, road construction

Role of Public Exp. in Development

→ Build infrastructure - roads, rails, logistics, power supply, irrigation

* Necessary social overhead capital for further Direct Productive Activities as per Hirschman.

→ Increase efficiency and productivity

* 14% logistic cost as % of GDP

→ Develop capabilities - health, education, skills

* 1.8% of expenditure in health

e.g. - Aayushman Bharat, Sarva Shiksha

→ Appropriate externalities in economy

* efficient agriculture through thrust to drip, sprinkler irrigation

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→ Role as a welfare state :- food subsidy, gas subsidy for holistic development - fighting hunger, malnutrition, poverty
e.g - PM POSHAN; NFSA

→ Supply public and merit goods - defence, national security - IAC Vibrant

→ Bring structural changes
* Industrial thrust of Mahalanobis plan to move towards industrialisation

→ Improve standard of living - swachh bharat, PM Awas Yojana

→ Taking up projects not possible by private sector
e.g - large dams - Bhakra Nangal

Hence, the key role of public expenditure is well reflected as it consists of ~10% of GDP of our economy.

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Q.5 (c) Explain how Neo Keynesian solutions will emerge for underemployment situation?

Underemployment refers to the situation when a person is employed but at a level below his expertise, skills and potential output.

e.g. B.Tech engineers applying for peon, clerk position in government jobs

Neo Keynesian solutions to underemployment

→ Neo Keynesians evolved Keynesian theory through :-

* Imperfect product market
* Wage rigidity due to constancy of price assumption
* Also assume rational expectation for all

→ Hence, not only wage stickiness but price stickiness due to efficiency wage, insider-outsider model, shoe-leather and menu cost impact employment.

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Solutions for underemployment

→ Fiscal policy such as government spending on infrastructure, asset creation

→ Monetary policy to aid investment
* However, not heavy use due to impact on inflation.

→ Market reforms to remove rigidity
* more competition, skilling of labor

→ Public expenditure such as unemployment-bonus, to aid consumption

Hence, Keynesian policies were followed post 2008 global financial crisis to provide solution to unemployment & underemployment provisions.

Q.5 (d) Explain Schumpeter's theory of development.

Schumpeter's theory of development states that growth involves creative destruction

Schumpeter argued that long run growth comes through :-

* innovations
* innovation results because of entrepre-neures wanting monopoly profit by bringing new products.
* innovation replace old tech.

Hence, Schumpeter deviated from old classical economics belief that markets passively move towards equilibrium until profits are 0.

* He believed that economic progress is not gradual but abrupt and disjointed due to new innovations.

→ Hence creative destruction bring new product, new methods of production and new tech.

* Existing players must innovate and give pathway to new.

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→ Through this schumpeter also explained the occurrence of business cycles :-

* Whenever an entrepreneur disrupts, the existing workers, product demand etc get impacted and the sector may face significant loss
↳ down cycle event-

* In turn, the down cycle frees up resources which can be used more productively leading to growth upturn
↳ upcycle event-

Hence, the creative destruction of world wide web best exemplifies Schumpeter's growth model.

Q.5 (e) Derive Hicksian demand curve using price rise in case of a Giffen good.

Giffen good is one whose demand rises when price increases (against law of demand)

eg → These are goods which are necessary and have only few substitutes

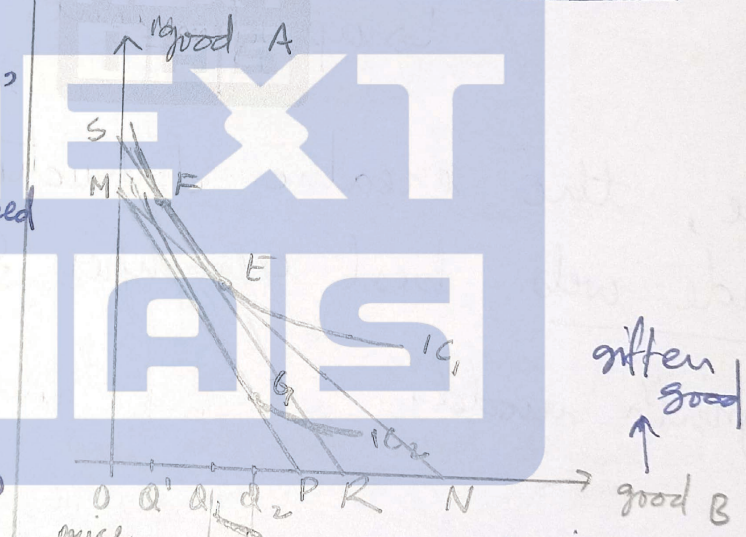
e.g. - Bread, wheat, rice

Hicksian Demand curve of Giffen good

→ In the fig 1, giffen good B price is increased from $P_1 \rightarrow P_2$

→ Hence, the income pricing line shifts to left from MN → MP

→ Hence for the customer, IC equilib moves



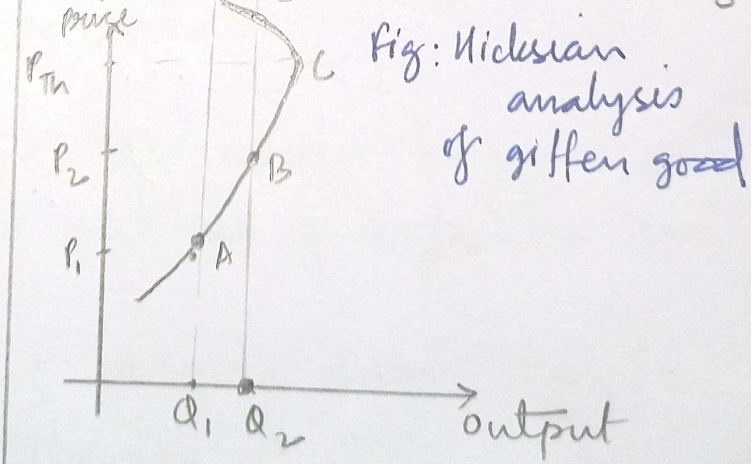


Fig: Hicksian analysis of giffen good

Fig: giffen good demand curve

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from $E(IC_1)$ to $G(IC_2)$

→ Since giffen good is very essential, consumer cuts the expenditure of other good to increase consumption of B

* Using variation of income RS, we can see Q_1Q' (EF) is the substitution effect due to price rise leading to fall in consumption

* However, a very large income effect ($Q'Q_2$) or FG, cause the final consumption at OQ_2

→ Hence the curve ABC in Fig 2 is the demand curve.

* However, the curve is upward sloping only till price OP_{Th}. This is because at Prices > OP_{Th}, high prices make even giffen goods unaffordable

Hence, government gives subsidies so that higher consumption of food items is possible.

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Q.6 (a) How is general equilibrium solution reached in an economy with two people, two commodities and one factor of production? 15

Candidates must not write on this margin

Assuming a perfectly competitive economy,

Two commodities < X, Y ; Two people < A, B

and single factor L

P_x - Price of X, P_y - Price of Y

Hence, general equilibrium is established when there is efficiency in exchange, allocative efficiency and efficiency of production are achieved.

General Equilibrium solution

→ Efficiency of exchange

* If the initial distribution was at T with A consuming OM of X and ON of Y and B the rest.

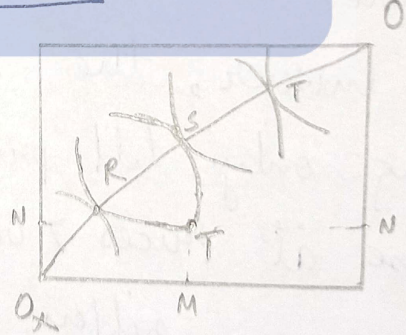


Fig: Consumption eq.

→ Hence exchange efficiency occur when both A & B bargain to consume at the contract curve in the region RS

Candidates must not write on this margin

hence, in equilib

$$MRS^{A}_{XY} = MRS^{B}_{XY}$$

Also, since Perfect Comp.

$$MRS^{A}_{XY} = MRS^{B}_{XY} = \frac{P_x}{P_y}$$

Efficiency of Production

→ since only one factor of production 'L' and all homogeneous

→ Hence in equilibrium wages for all L, irrespective of being used in producing X or Y remain same.

$$\therefore w_L = (MP_L)_x = (MP_L)_y$$

$$= P_x \cdot (MP_L)_x = (MP_L)_y$$

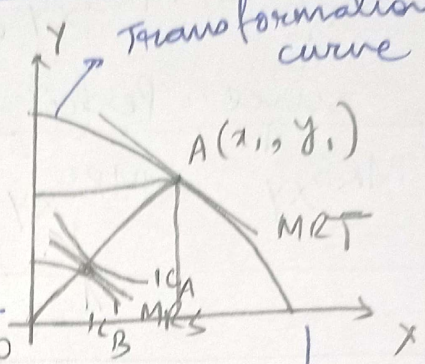
$$\therefore \text{in eq.} \quad \frac{(MP_L)_x}{(MP_L)_y} = \frac{P_y}{P_x}$$

and $w_L = P_x \cdot (MP_L)_x$

Candidates must not write on this margin

Efficiency of transformation

* In general equilib., the production will be according to tastes



Hence, $MRS^{A}_{XY} = MRS^{B}_{XY} = MRT_{XY}$

if $MRS_{XY} > MRT_{XY}$ ⇒ more X is desired but less is produced hence net gain if produced more.

Hence, the above three criteria fulfil the general eq. conditions.

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6 (b) Explain the quantitative and qualitative methods of credit control. Which one is better for inflation targeting? 20

Candidates must not write on this margin

The recent monetary tightening through interest rate, aggressive/hawkish tonnes reflect the usage of quantitative and qualitative methods of credit control.

Credit Control

→ It refers to instruments used by central banks to limit credit supply in the economy.

→ Generally used to fight inflation, bring macroeconomic stability and orderly economic growth.

e.g - raising repo, bank rates

Two types — quantitative
— qualitative

Quantitative Credit Control

→ These refer to direct intervention of central bank to limit money supply and reduce credit demand.

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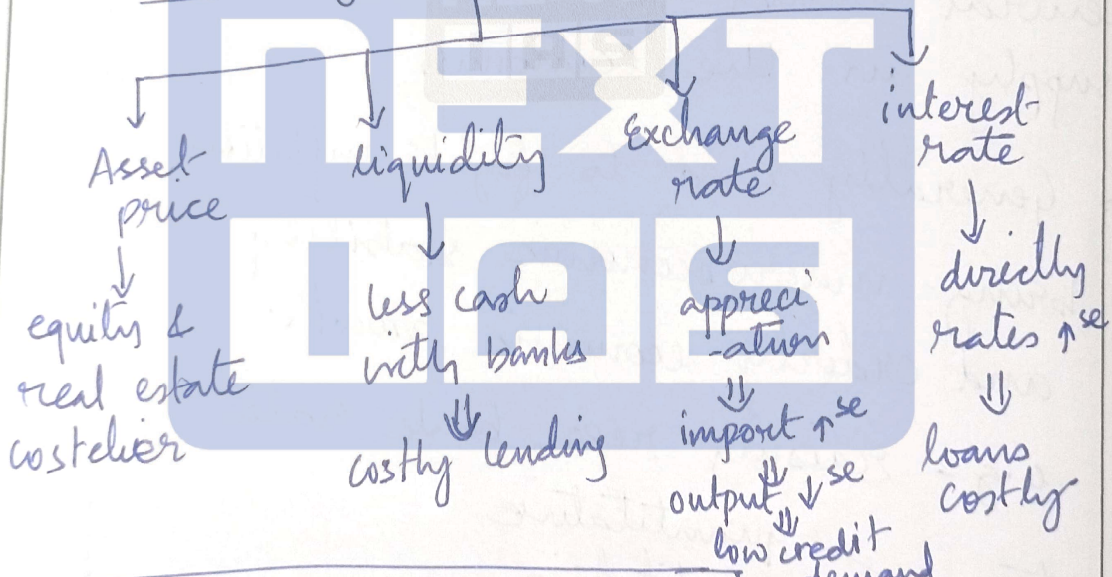
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→ Through these, credit control across all sectors is enforced.

→ Main instruments used are :-

* repo operations - raising repo rate
* selling OMOs - sucking liquidity (durable)
* Increasing bank rates
* MSS bonds to suck large capital inflows and limit money supply

→ Channels of impact



Qualitative Credit Control

→ These are persuasive techniques used by central banks to bring credit control.

Candidates must not write on this margin

→ These involve moral suasion, sectoral credit controls to give signal.

Example - policy guidance - neutral, tightening, accomodating of RBI MPC

→ Generally informal channels of comm.
* RBI governor talks with banks are used

Use in Inflation Targeting

→ In inflation targeting, a central bank is explicitly mandated by law to control inflation.
* gives primacy to inflation in pursuance of other objectives - growth, forex
* RBI Act 2016 mandated RBI to have (4 ± 2)% inflation targeting goal in medium term

Benefits of Quantitative

→ Brings explicits reduction in credit growth ⇒ money supply ↓ ses ⇒ WACR (call rate)

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and medium term interest rate above inflation ⇒ positive real interest rate

→ Provides the path for inflation attainment
→ Also, enables rule based policy making ⇒ low time inconsistency problem
→ General market mechanism through broad guidance ⇒ low chances of credit allocative inefficiency

Benefits of Qualitative

→ Works with the aim of minimal market disturbance
→ Don't need a sledge hammer (quantitative) where needle suffices
→ helps avoid knee jerk reaction

Hence, in times of high deviation from target – quantitative should be used whereas once near target more thrust on qualitative method to reach the target.

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(c) Explain Taylor's rule. 15

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Taylor's rule was given by John Taylor, executive in US govt to frame a rule based interest setting policy to tackle inflation

Taylor's Rule

$$\text{interest rate } (r) = \text{inflation rate } (inf) + 0.5(inf^* + inf) + 0.5(u^* - u) + \text{real rate } (r^*)$$

where,

u = unemployment level

u^* = natural unemployment rate

r^* = real desired interest rate in economy

inf^* = target inflation level

r = repo/federal fund rate → set by RBI/Fed

functioning

→ If inflation rate rises by 1%, then

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as per rule, RBI will raise repo rate by 1.5%.
- → 1% due to ↑se in inf
- → 0.5% due to 0.5(inf − inf*) diff

→ similarly, if unemployment (u) rises in the economy (↓), the RBI reduces repo rate by 0.5%. — $0.5(u^* - u)$

Significance

→ More targeted towards change in inflation than unemployment
- * if 1% ↑se in inf — 1.5% ↑se in rate
- * if 1% ↑se in u — 0.5% ↓se in rate

→ Solves time inconsistency problem often faced by central banks

→ Monetarist framework : rule based policy making — Friedman

→ Easier adaptation and prediction ⇒ least market disruption

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Issues

→ New classical economics - rational expectation ⇒ useless in tackling inflation because predictable

→ Too restructive in nature

→ May introduce financial instability

→ Keynesians : tyranny of money

However, despite its fallacies, Taylor's rule is a useful model in predicting the direction of central bank repo rate.

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Q.7 (a) Examine the impact of favorable supply shock when expectations adjust gradually in an adaptive manner. 20

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Supply shocks are those which impact real variables such as output, employment as per classical economists

e.g - corporate tax rate cut 25/18%.

Impact of favorable supply shock

Given :-

* adaptive expectations with gradual change

∴ Business have perfect information but laborers adapt slowly

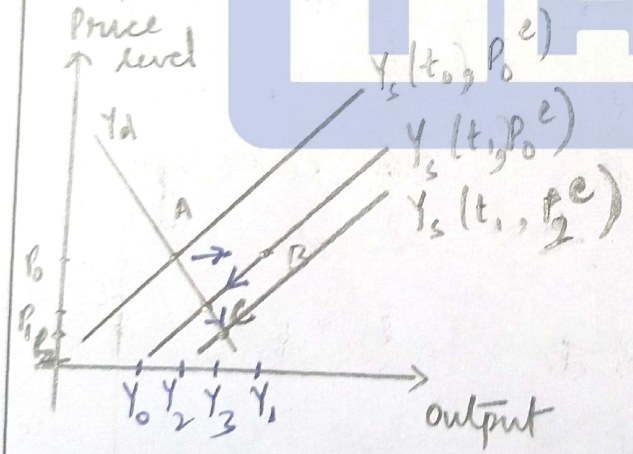


Fig: Impact on output

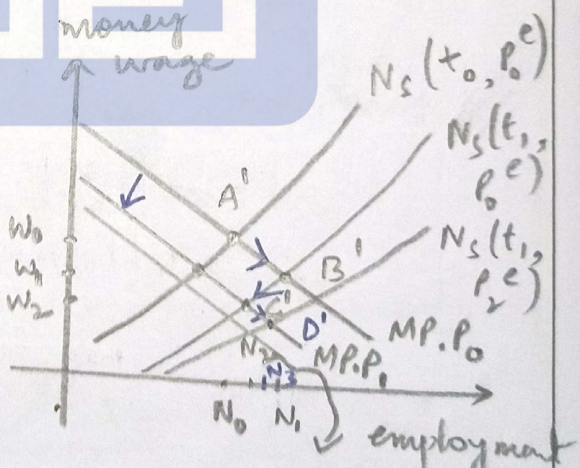


Fig: Impact on employment & money wage

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Analysis

→ If a sudden supply shock occurs (say tax ↓se from $t_0 \rightarrow t_1$)

⇒ SAS curve shifts right because suddenly more labor will work at the same money wage

→ labor supply curve shifts from $N_s(t_0, P_0^e) \rightarrow N_s(t_1, P_0^e)$

→ In the immediate run

* Industry and workers both don't adjust to shock

* Hence the improve efficiency causes rising employment from $A \rightarrow B'$ with reduced wage $(W_0 \rightarrow W_1)$

* Also, output immediately rises from $Y_0 \rightarrow Y_1$ with Price from same

→ In the short run

* Since slow adaptive expectations, business adjust to changes but workers don't

* Hence, Price falls from $P_0 \rightarrow P_1$

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* This happens because marginal cost ↓ se due to improved efficiency.

* Also, the labor demand curve adjusts to new price (P_1) and shifts to left

* However labor supply remains same at old Price expectation P_0^e

⟹ Hence, employment falls from $N_1 \rightarrow N_2$ at C' along with fall in money wage to W_2

→ Also, output adjusts from $Y_1 \rightarrow Y_2$

In the **long run**

→ Workers also observe the fall in prices and adapt themselves to new reality.

→ The supply curve shifts right in Fig 2 to $N_S(t_1, P_2^e)$

* Also, labor demand also adjusts to new long run equilib. price P_2 s.t $P_2 = P_2^e$

→ Hence the overall labor employment ↑es from N_2 to N_3 (C' to D')

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→ similarly, the supply output shifts to right from $Y_s(t_1, P_0^e)$ to $Y_s(t_1, P_2^e)$

→ Hence, output ↑ses from $Y_2 \rightarrow Y_3$ with final equilib at C

Overall change

1. Output : $Y_0 \rightarrow Y_3$
2. Employment : $N_0 \rightarrow N_3$
3. Price level : $P_0 \rightarrow P_2$

This is the mechanism of supply side adjustment.

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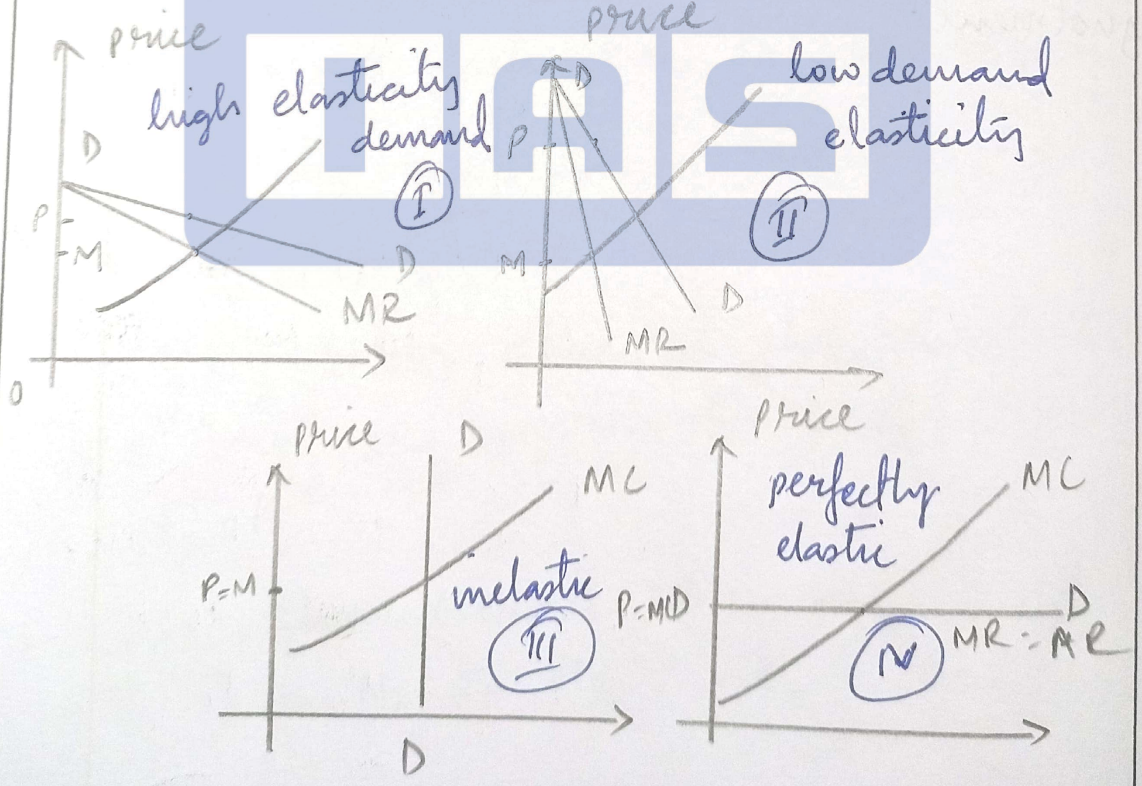
Q.7 (b) Monopolist has more power if elasticity of demand is low but it has its limit. Discuss. 15

A monopolist is one who is a single player in the market with barriers to entry and no close substitute of product
e.g. - Indian railway monopoly

Power of monopoly & Demand elasticity

→ Monopoly power can be defined as how much price (P) set by monopolist is above marginal cost

$$\underset{\text{(power)}}{M} = \frac{P-MC}{MC}$$



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Impact of demand elasticity

* In fig IV, the perfectly elastic demand signify that in equilibrium, Price & marginal cost are same

∴ P = MC ⇒ 0 power

→ This generally doesn't occur in real world. However, theoretically ∞ elastic ⇒ 0 monopoly power

* In fig (I) PM is the price difference in a highly elastic demand market

* The gap PM here is lower than PM in fig (II) which is low elastic.

→ This is because, in elastic market, while close substitutes may not be there but other factors - trades, govt regulation help in reducing monopoly power

→ However, as seen in fig II, the monopoly power is very high when low elasticity

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→ However, if the demand curve becomes completely inelastic, then monopoly charges P = MC

* hence no monopoly power in this case – Fig IV

→ Also, at very high monopoly power, government generally introduces profit windfall tax ⇒ ↓ng profits & power

e.g. – windfall tax by Indian govt.

Hence, though elasticity helps in monopo-ly power but only to a limit.

(c) Explain trade adjustments and protectionism if one country has advantage due to external economies of scale and first mover advantage. 15

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External economies of scale refer to lowering of cost with time incurred in each production of goods, due to factors such as learning by doing, improvement in overall infra etc.

e.g. - cost reduction in cars production

External Economies and Trade

→ Due to external economies, it is possible for a country - A to gain advantage over B even though overall A is less efficient in producing the product.

→ The advantage occurred because A moved first and established dominance.

* Here because A started 1st, it captured world market D_W and sells 400 units at ₹3

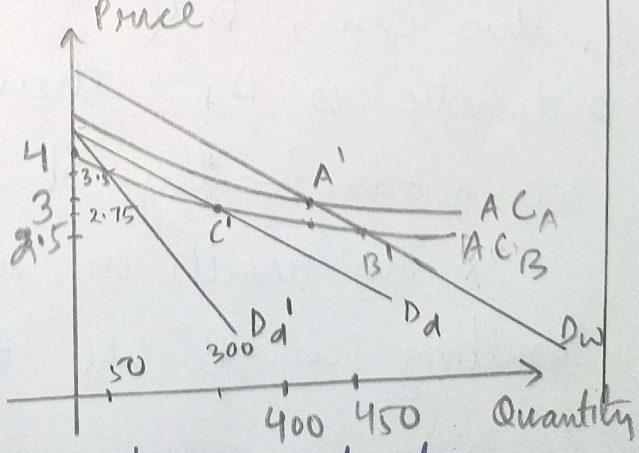


Fig: 1st Mover advantage

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→ However since B's entry cost is at £4, it will never be able to match A even though Avg cost $AC_B < AC_A$ at all quantities

→ Hence, protectionism is advocated in this case

Protectionism and Trade Adjustment

→ The above case result in inefficient production and results in loss of consumer welfare

* B could have supplied 450 quantity at £2.25

→ To protect B, tariff imposition is preferred over domestic market to enable B to reach external economic efficiency

→ In this case, if the demand curve of domestic is D_d, then B can supply 300 goods locally at £2.75

* This results in sufficient protection resulting in B able to compete in

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global market efficiently ~~as~~

Case of Ineffective Protection

→ If the domestic demand curve was such that- eg. price post tariff > world price of A ⇒ B won't be able to produce for global market

* If D_d' were the local demand curve, then so qty is supplied by B at ₹3.75

* Hence any tariff protection is ineffective in this case.

Hence, India has used infant industry protection in our electronics sectors to give boost to our mfg through PLI scheme.

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