NEXT IAS

(To be filled by candidate)

Name of Candidate : Mohd Ashfaq

Roll No. : ECFC2321220

Registration Number : MA2230001381C Date of Examination : 4th/Sept/2023.

Exam Centre : Old Rajinder Nagar ☐ Bhopal ☐ Online ☑

CSE (MAINS) TEST SERIES - 2023

Test-07

Dated : 27-08-2023

ECONOMICS OPTIONAL

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	15			
2. (b)	17	15			
2. (c)	20	20			
3. (a)	24	20			
3. (b)	28	15			
3. (c)	31	15			
4. (a)	34	15			
4. (b)	37	15			
4. (c)	40	20			
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	15			
6. (c)	60	20			
7. (a)	64	20			
7. (b)	68	15			
7. (c)	71	15			
8. (a)	74	15			
8. (b)	77	20			
8. (c)	81	15			
				Grand Total	

Remarks

Observations:

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Q1

(a) Trade as engine of growth is explained by Neo-keynesian theory of "trade feed back effect"

उम्मीदवारों को इस हाशिए में नहीं लिखना चाहिए
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Assumptions

① trade happens between large country and small country.
② There is quid-pro-quo-trade.
③ existence of perfect competition
④ No trade barriers or transportation costs.

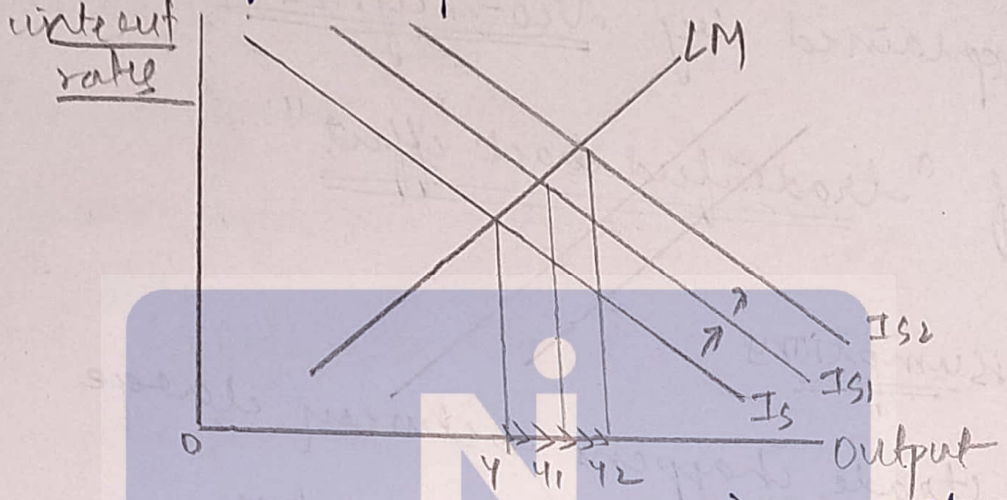
Model.

⇒ when larger country opens up trade, the small country imports from the large country.

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⇒ exports of large country rises, and IS shifts right.



⇒ with rise in exports, income of large country citizens increases. This increases demand for small country's imports.

⇒ Income of small country rises

⇓

⇒ Exports of larger country rise [IS shifts again]

This whole chain reaction continues and it is established that trade acts as engine of growth as output rises continously.

उम्मीदवारों को हाशिए में नहीं लिखना चाहिए
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(b)

Ans

Agriculture is an important sector for development, specially for developing country like India with largest population in the world.

Agriculture contributes to development

⇒ Increase the food security in the country thereby reducing famines & hunger.

⇒ helps in balanced development by increasing the income of rural population

⇒ provides employment to almost 1/5th of India's labor force.

उम्मीदवारों को इस हाशिए में नहीं लिखना चाहिए
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⇒ It also helps in exports and earning foreign exchange.

Development contributes to agriculture

⇒ It increase the aggregate demand for food with rising income level.

⇒ Industries create demand for the agricultural produce

ex> food processing industries.

⇒ Development of technology improves the productivity of agriculture.

⇒ Development increase trade and create global demand for agricultural products.

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उम्मीदवारों को इस हाशिए में नहीं लिखना चाहिए
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(c)

Kaldor and Kalecki's theory of income distribution had many similarities. They both explained the share of wages & profits in the income.

Kaldor: $\frac{P}{Y} = \frac{I/Y - s_w}{s_p - s_w}$

Kalecki: $\frac{W}{Y} = \frac{1}{\frac{Y}{W} \cdot \frac{I}{W} - 1}$

[Differences]

Kaldor	Kalecki
☐ equation reflected share of profits in total income	☐ equation reflected share of wages in total income.

C-AVZ-0-1

- Used difference between marginal propensity to save ($s_p > s_w$) as base for profit
- Concluded that investment is key for increasing the profit share
- Stated that during recession capitalists will not reduce wages and reduce their share of profits [IV]
- Used monopoly power of capitalists 'π' as base for profits.
- Rise of monopoly power a major reason for rise in profits.
- Stated that wages stayed constant during the past. Business cycles impact the share of wages.

Both Kaldor and Kalecki gave their own versions of distribution theories as an improvement over classical theories.

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(d)

Ans

Monopoly power refers to the ability of the firm to charge a price above their its marginal costs $(P > MC)$.

In imperfect markets the monopoly power exists, but the degree of power is different.

Pure Monopoly $\Rightarrow$ $MC = MR$, $P > MC$.

↳ enjoys super normal profits and also produces at monopoly quantity. Highest degree of monopoly power.

Monopolistic Competition

↳ Enjoys monopoly power of

C-A C-AVE-O-1

certain degree due to product diff-
erentiation
↳ however cannot enjoy monopoly
profits due to free entry & exit
∴ less degree of monopoly power.

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Oligopoly

→ monopoly power exists. Entry is restricted and firms are not homogenous ∴ higher than MC.

Duopoly → No monopoly power under simultaneously price setting.
↳ highest monopoly power under collusion
↳ the Quantity leader & price leader also enjoys a certain degree of monopoly power.

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(e)

Tobin's "q" theory is used to explain interest sensitivity do money demand.

$$q = \frac{\text{Market value of company's assets}}{\text{Actual value of company's assets}}$$

⇒ when there is a boom, "q" is usually high. Therefore, it is easier for the firm to borrow directly from the market without taking loans ~~&~~ ~~issuing~~.

⇒ The "interest sensitive" to the money demand in this case is very low.

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⇒ whereas, during a recession or slowdown, "q" is very low. The company will find borrowing from market difficult. Therefore it excessively depends on money market

⇒ Hence, the interest sensitivity of money demand is higher.

"q" is used to explain the interest sensitivity of money demand by Tobin.

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Qy

(a)

Subsidy is a fiscal policy instrument used to incentivise production, or to reduce the burden of price on the consumers. There are different types of subsidies and they are used for different purposes. Based on the method of implementation. They are

Direct Subsidy

⇓

No interference with market allocation. and no dead weight loss.

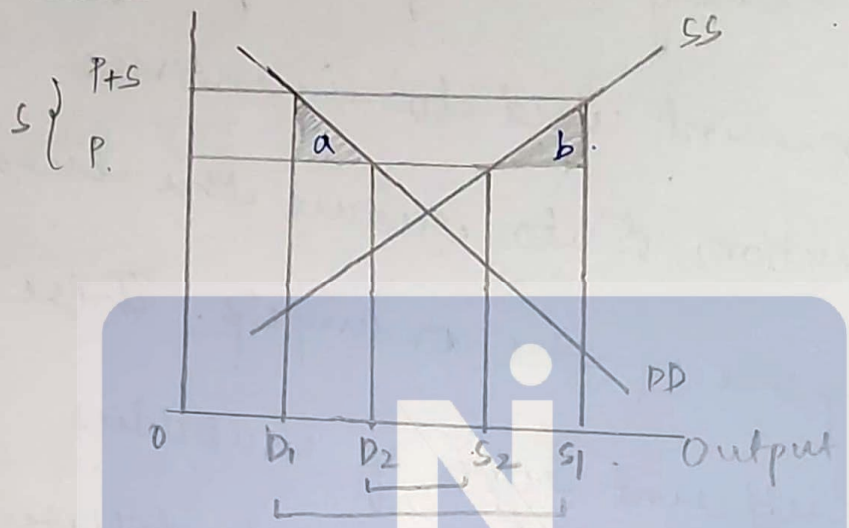
Indirect Subsidy

⇓

Influences prices in the market and creates deadweight loss.

उम्मीदवारों को इस हाशिए में नहीं लिखना चाहिए
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Impact of per unit Subsidy.



if a per unit "export" subsidy of "S" is imposed by a small nation on the commodity X.

⇒ The price paid by the importers is P, where as, the price ~~paid~~ received by the domestic exporters is P+S.

⇒ "S" x S1-D1 is the cost of subsidy to the government.

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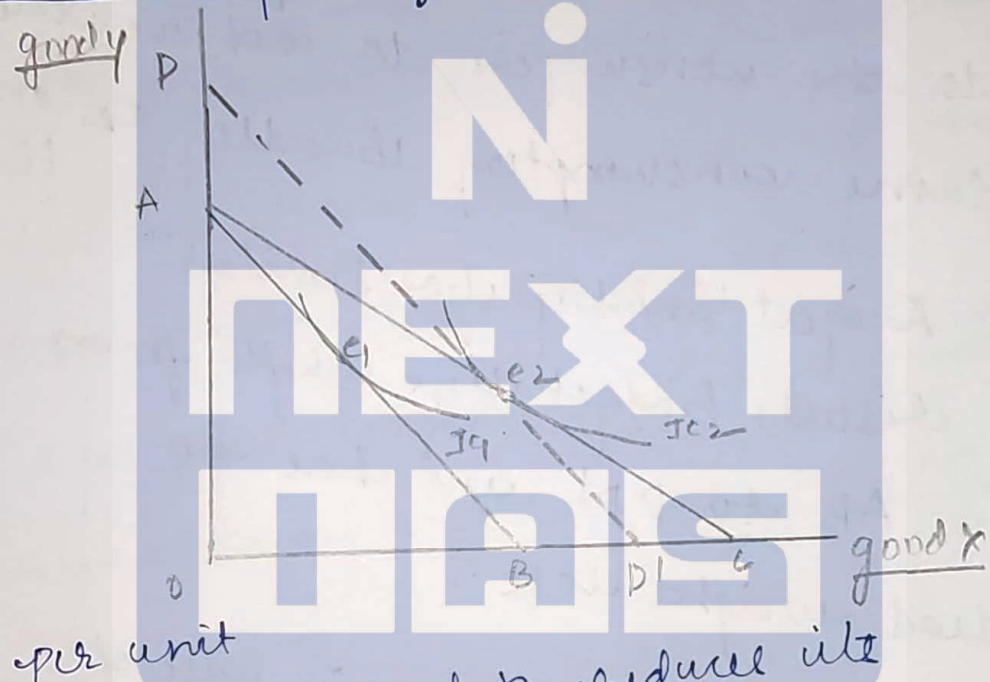
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⇒ per unit subsidy creates dead weightloss.

$\Delta^{le}a$ → consumption distortion

$\Delta^{le}b$ → production distortion.

illustration using indifference curves.



per unit

⇒ subsidy on good x reduces its price. The budget line shifts from AB to AC. as the purchasing power of consumers has increased.

⇒ The overall price effect of subsidy is

NEXT IAS

movement from e_1 to e_2.

⇒ As seen easily, per unit subsidy creates dead weight loss.

⇒ Instead, A direct subsidy of the same amount can be given directly to the consumer to achieve the same consumption bundle e_2 on IC_2

⇒ Direct subsidy has similar result, Budget line shifts from AB to DD' and has no dead weight loss.

However, in case of perfect substitute or perfect compliments, the direct & in-direct subsidy have similar market impact.

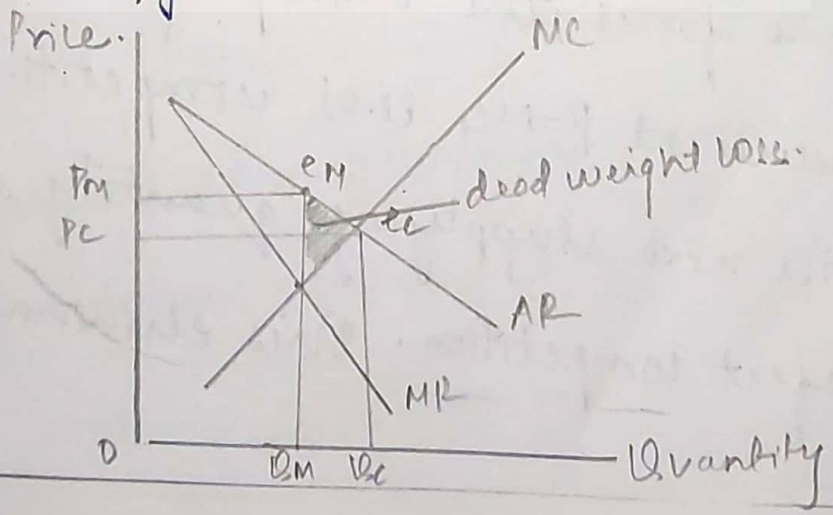
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(b)

Monopoly charges price above its "marginal cost" to maximize its profit → it reduces consumer surplus.

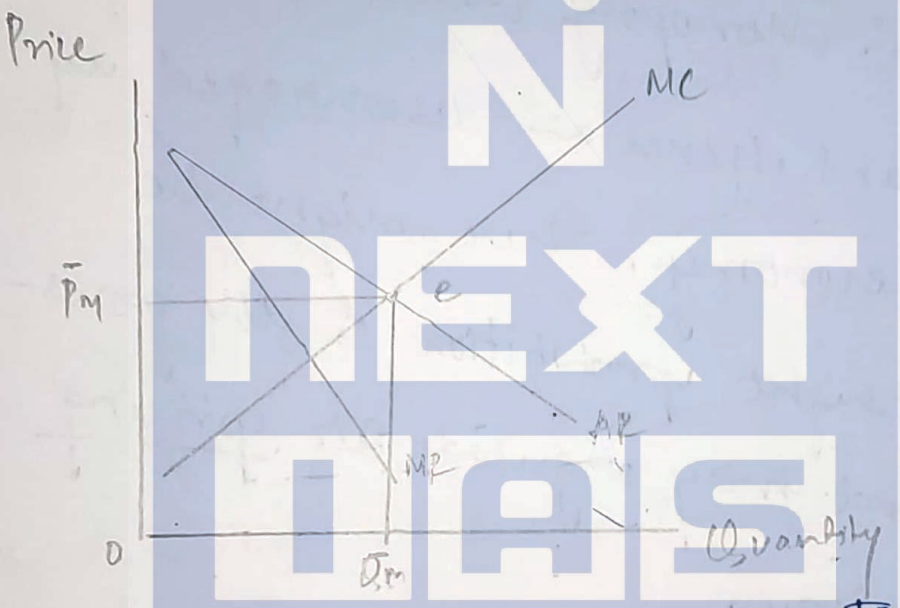
∴ Monopoly creates deadweight loss and there are discouraged in the economy. There might be outright prohibition of the government may regulate its pricing strategy.



Marginal pricing policy

⇒ In this case the government sets the price of the monopoly is product equal to its marginal cost

$P = MC$



⇒ This forces the monopoly to produce at P=MC (i.e.) competitive price and supplying quantity of perfect competition. This eliminates

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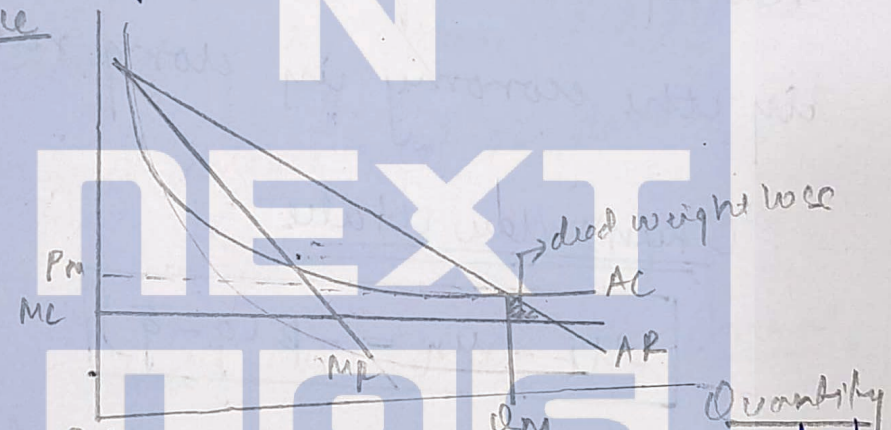
dead weight loss.

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Average cost pricing

⇒ usually done in case of Natural monopolies where it has long falling Average cost curve.

⇒ It doesn't ~~did~~ eliminate the deadweight loss but reduces it



Therefore, if government controls pricing then monopoly reaches equilibrium in the above ways.

C-AVZ-C

Q

NAIRU refers to "non-accelerating inflation adjusted rate of unemployment" → it was given by the Neo classical economist Okun's to explain the prevelance of a natural rate of unemployment in the economy in long run.

Okun's law states

$$u_t - u_n = -\beta(q - \bar{q})$$

where, u_n refers to natural unemployment rate.

phillips curve states

$$\pi_t = \pi_e - \alpha(u_t - u_n)$$

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C-NEZ-0-1

when $\pi_t = \pi_e$,

$u_t = u_n$ → This is NAIRU.

⇒ It is the average rate of unemployment that is observed in the economy in the past couple of years.

⇒ According to Okun, NAIRU is not pre-determined or divine, it can be influenced using policy tools that result in structural reforms

⇒ During periods of Boom, the unemployment rate is below its natural level. However,

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this happens only in shortrun.

⇒ In long run, the workers change their expectations and demand a higher wage (increase price expectations)

⇒ In periods of recession, the unemployment rate is ~~below~~ above the natural level.

⇒ NAIRU may be reduced through
- ↳ labor law reforms.
- ↳ transparency in labor markets
- ↳ Increasing ease of doing business ...etc.

In Indian context, NAIRU is around 5-6% of total labor force.

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(5) (a)

Ans

Baumol and Keynes both recognised the role of interest rate in effecting the demand for money. However, they both differed in very fundamental aspects.

Keynes

⇒ considered transactions demand of money independent of interest rates

⇒ But, speculative demand of money to be inversely related to the interest rate.

if i is low ⇒ speculative dd is higher.

if i is high ⇒ speculative dd is low.

उम्मीदवारों को इ... हाशिए में नहीं लिखना चाहिए
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$$\frac{M_d}{P} = ky - hi$$

Baumol

⇒ Unlike Keynes, he considered in transaction demand of money directly related to interest rate

⇒ didn't acknowledge speculatory demand.

$$K = \sqrt{\frac{2by}{r}}$$

high r ⇒ low transaction dd.

low r ⇒ high transaction dd.

Therefore, Keynes and Baumol differed in the type of money demand they considered.

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(b)

Ans

Public expenditure occupies a central position in the process of development.

⇒ Economists like "kuznets" acknowledge the role of public sector in welfare activities and reducing inequalities.

⇒ Mahalnobis also propounded the position of "commanding heights" to public sector in industrialization

⇒ It helps in crowding in private investment in the agriculture sector

⇒ promotes private investment in

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other sectors also like roads, water plants, power plants -- etc using PPP mode.

⇒ Crucial for provision of public goods like defence, law & order.

Ex DRDO.

⇒ Crucial for equitable provision of club goods Ex education, health.

⇒ Crucial for strategic industries.

Ex Space, Atomic, Banking.

⇒ Public sector helps in employment generation and balanced regional development.

Overall, public sector is needed to provide the fruits of capitalist economy to the weaker and poorer sections.

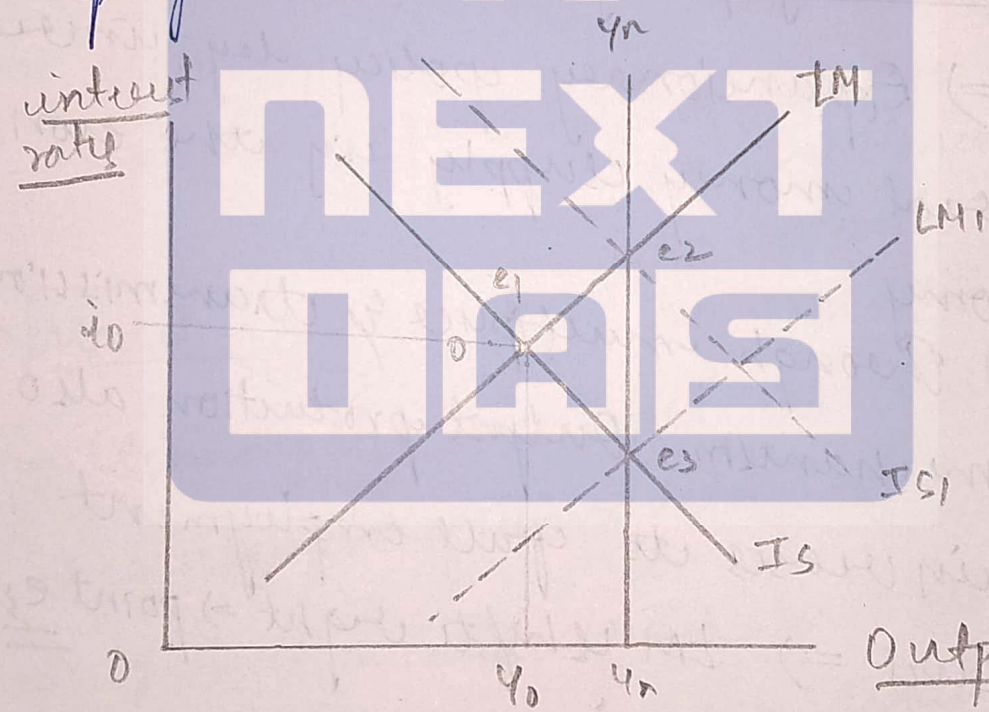
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C-AVZ-0-

(c)

Ans

Underemployment is a situation where, the level of employment in the economy is below "full employment" level. (i.e) There exists involuntary unemployment due to deficient demand.



The equilibrium of IS-LM curves leftwards to the full employment

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level.

fiscal policy

⇒ expansionary policy by increasing Government spending or reducing taxes

⇒ shifts IS curve to right and upward to point e_2.

Monetary policy

⇒ Expansionary policy by increasing real money supply in the economy

⇒ Through multiplier & transmission mechanism, output production also increases to full employment level ⇒ LM shifts right ⇒ point e_3

Therefore, Expansionary policies are solution to under-employment in Neo-Keynesian models.

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(d)

Ans. Schumpeter's theory of development is based on "creative destruction"

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[Assumptions]

① perfect competition

② Innovation ⇒ sudden and discontinous.

③ existence of circular flow in the economy

⇒ No leakages ⇒ No savings
No investment
No interest rate
No price rise.

[Model]

⇒ Schumpeter identified the basic requirement of innovation as "credit".

⇒ Innovation needs credit that is a withdrawal from the circular flow.

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⇒ Creation of Bank credit

⇓

demand of money > supply

⇓

inflation (price of old commodities rise)

⇓

low AD and closure to old firms

⇓

Innovation occurs

⇓

Old commodities become obsolete. firms exit the market as P<MC.

⇓

for new product P>MC due to Monopoly, IPR and legal protection

⇓

Credit is paid back ⇒ circular flow re-established.

Schumpeter said that innovation is necessary for development. and it destroys old commodities. New firms grow at the cost of old. However, Schumpeter says, if innovation is discouraged growth is stagnated in the economy.

C-1912-0-1

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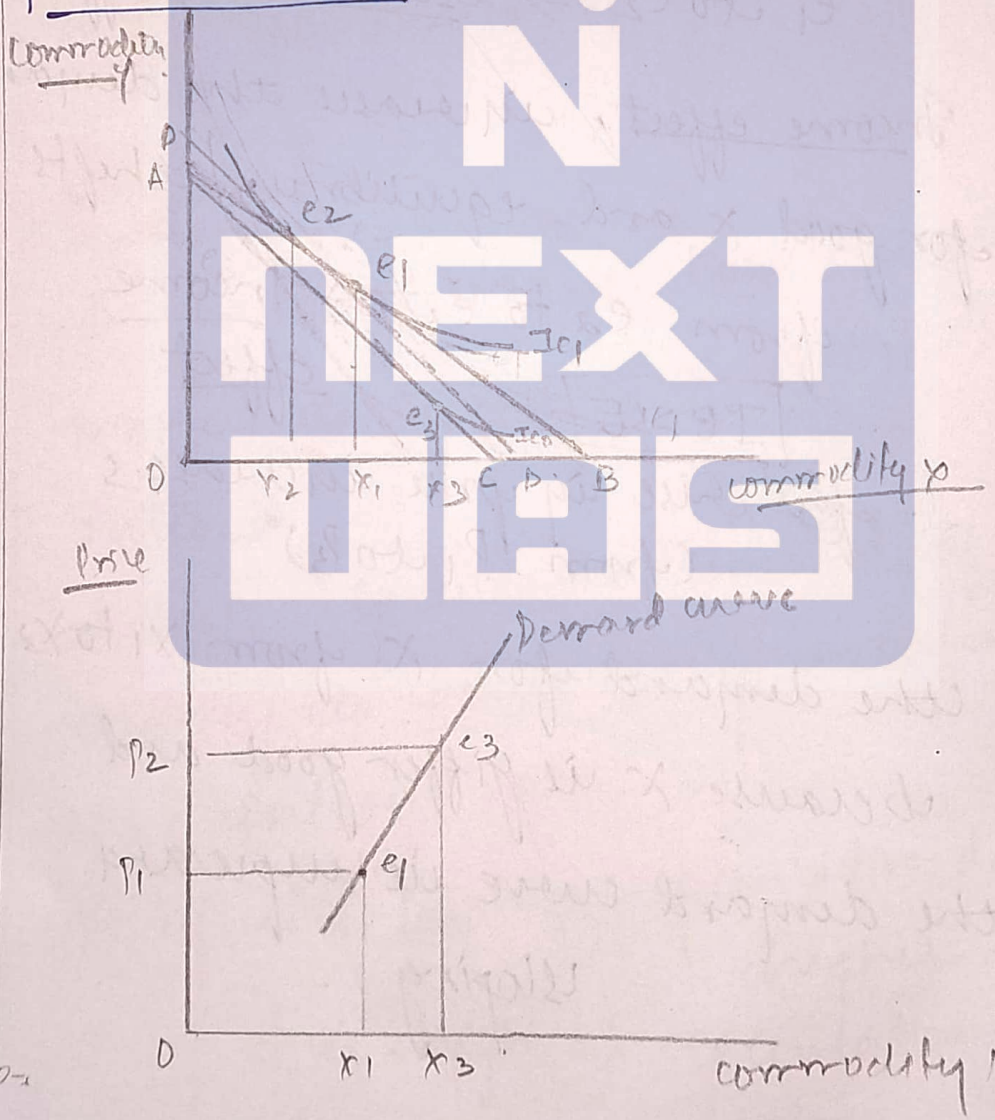
(c)

Ans.

Hicksian demand curve is derived by keeping the purchasing power constant in terms of original utility level.

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Illustration :



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⇒ when price rises, the budget line AB shifts to A'C.

⇒ "Hicksian" compensation involved "compensated dd curve" tangent to the initial IC curve at e_2.

e_1 to e_2 ⇒ substitution effect.

⇒ Income effect, increase the demand for good x and equilibrium shifts from e_2 to e_3 ⇒ Income effect

IE > SE

∴ rise in price increases (from P_1 to P_3) the demand for x from x_1 to x_3 because x is giffer good and the demand curve is upward sloping.

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Synergy Study Point Pune

U.P.S.C.

Q4

प्रश्न की संख्या दीजिए (a)
Enter number of question

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Expectations adjust gradually in a Neo classical model of aggregate demand and aggregate supply.

Assumptions

① Imperfect competition

② Adaptive expectations: wages are adjusted by workers based on expected prices.

wage setting equation

$$W = P^e f(u, z) \quad \text{— (1)}$$

③ firms can set prices. Hence,

price setting equation

$$P = A(1+u)\frac{W}{A} \quad \text{— (2)}$$

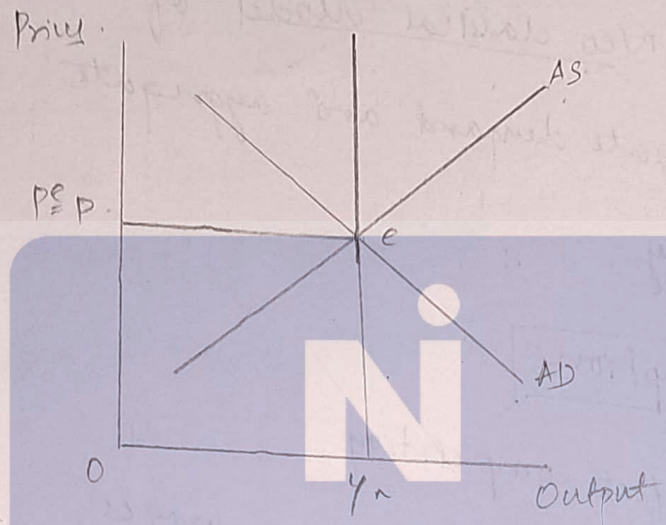
$u \rightarrow$ markup above marginal cost

④ AS curve is derived using (1) & (2) and is upward sloping.

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⑤ Aggregate demand curve is borrowed from Neo-Keynesian analysis.



⑥ at equilibrium $P = P^e$ and $Y = Y_n$

Impact of favourable supply shock.

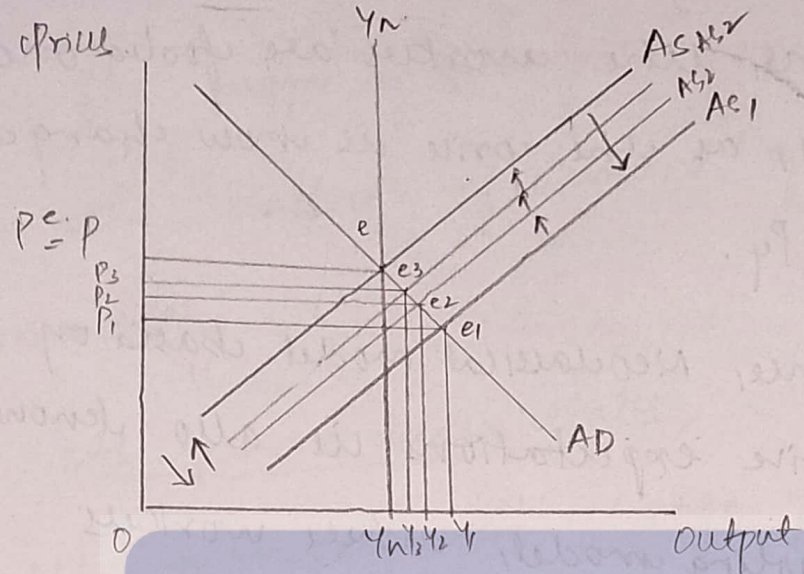
⇓

it might include discovery of a new resources, or invention of a cutting edge technology that increases the production possibilities of the economy.

Hence, AS curve shifts rightward.

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⇒ AS shifts rightward, the output expands from Y_n to Y_1 in short run.

⇒ The price fall and $P_e > P_2$.

⇒ Hence, in next period the workers revise expectations, $P_e = P_2$, and the AS curve shifts backwards to AS_2.

⇒ In next period the price is P_3.

Hence, the workers are "fooled".

⇒ Based on this, the workers further revise their expectations to $P_e = P_3$ in next period. AS shifts to AS_3.

However, the workers are fooled once again, as the price is now changed to P_4.

⇒ Hence, Neoclassical model based on adaptive expectations is also known as fooling model, where workers are prone to make repeated systematic errors

⇒ This continues till, AS completely shifts back to its initial level and Output is back to full employment

$[P = P_e]$ & $[Y = Y_n]$

∴ A favourable supply shock increases output in short run, but in long run the workers revise their expectations and Output is back to full employment.

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⑥

Ans

The degree of monopoly power depends on the "elasticity of demand" of the commodity.

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As Lerner's index states, the monopoly can charge price above its marginal cost if the elasticity of demand is lower

$$\frac{P-MC}{P} = \frac{1}{|ed|}$$

case 1: when elasticity of demand is perfectly elastic, (i.e) $|ed| = \infty$.

$$\frac{P-MC}{P} \to \frac{1}{|ed|} = 0.$$

$P = MC$ → perfect competition and "Zero" monopoly power.

C-AUZ-0-1

Case 2: when elasticity of demand is $|ed| > 0$, but $|ed| < 1$. [Inelastic case]

$$\frac{P-MC}{P} = \frac{1}{0.5}$$

$$= 2$$

Case 3: when elasticity of demand is [elastic.]

$|ed| > 1$.

$$\frac{P-MC}{P} = \frac{1}{1.5} = 0.6$$

∴ It is established that lower the $|ed|$, higher the monopoly power.

However, Monopoly won't operate on the inelastic portion of AR curve because of "2" reasons.

① MR is negative

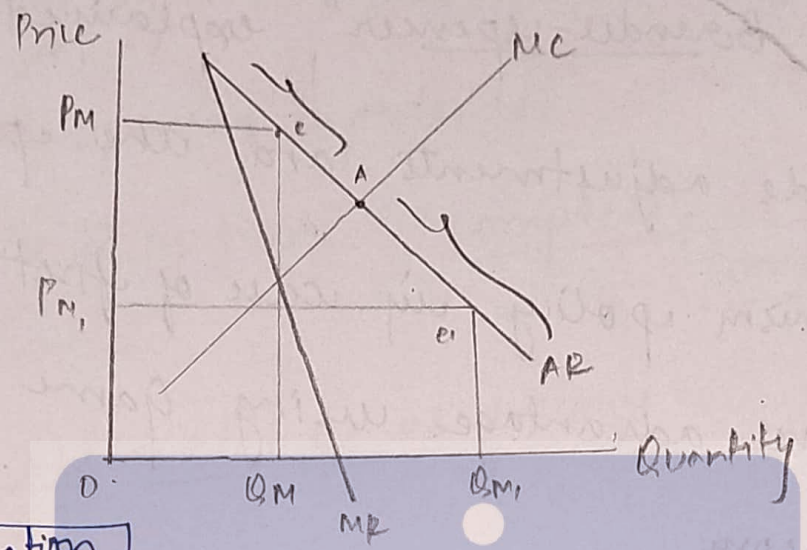
② it can always increase its profits by increasing price

उम्मीदवारों हारिए में लिखना चाहि Candidates must not write on this margin

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as the demand is inelastic.



Illustration

⇒ In the above demand (AR) curve, the portion below A point is inelastic.

⇒ at P_{M_1} and Q_{M_1}, the MR is negative.

∴ As monopoly's main goal is profit maximization it operates on the elastic portion of AR curve.

∴ Monopoly power is between

$$1 < |ed| < \infty$$ //.

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Q

Ans "Brander-spencer" explained trade adjustments and the protectionism policy in case of first mover advantage using Game theory

Assumptions

① 2 ~~air~~ manufacturing firms. plane from a country

Airbus – UK
Boeing – US

② Boeing has first mover advantage and it is already in the manufacturing business for domestic market.

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③ pay off matrix is formed, when, after opening up trade, there are only 2 options, "compete, do not compete"

pay off matrix is as follows.

Boeing \ airbus	compete	do not compete
compete	(-5, -5)	(100, 0)
do not compete	(0, 100)	(0, 0)

in million dollars

Illustration

As Boeing has first mover advantage, (i.e) it will always compete (dominant strategy)

⇒ Nash strategy for airbus is to not compete as it may close 5 million dollars if it competes.

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∴ Nash ⇒ Boeing — compete
Airbus — do not compete

post opening of trade.

Protectionism → if UK government provides subsidy of 20 million dollars to Airbus. if it decides to compete

charged payoff Matrix [export subsidy]

Airbus / Boeing	compete	do not compete
compete	(-5, 20)	(100, 0)
do not compete	[0, 125]	[0, 0]

The dominant strategy for Airbus is not charged to "compete". Nash happens at "Compete, compete" and Boeing is driven out due to losses.

However, such Beggar-thy-neighbour policies may invite retaliation and lead to trade war

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C-AVZ-0-1

Q8

(a)

Balance of payments is always at (BoP) balance. because of the accomodating transactions made at the end. (change in forex)

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Components of BoP:

Current account

- Net exports of trade in visible goods.
- Net invisible trade
  - includes trade in services.
- Net flow of remittances.
- Net factor income from abroad.

Capital Account

- Net FDI inflows.
- Net FII inflows.

□ Net borrowings [includes external commercial borrowings]

The above are the autonomous components of BoP. Based on this there might be either be a surplus or deficit in current account, But Capital account accomodates the current account deficit/ surplus and Hence, BoP balance is maintained.

Case 1 current account deficit

In this case accomodating forex transactions as "Sales of forex" is credited to Capital Account for BoP Balance

Case 2 current account surplus

In this case accomodating forex transactions of "purchase of forex"

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C-AVZ-0-

is debited from capital account

∴ BoP is always balanced.

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Policies to improve BoP:

- ☐ Low fiscal deficit
  - ↳ fiscal prudence by reducing wasteful expenditures like subsidies.
- ☐ Low current account deficit
  - ↳ promotion of exports and promoting domestic manufacturing (reduces imports)
- ☐ Controlling inflation
  - ↳ to keep domestic commodities on par with foreign commodities $P = 1$.

∴ Macroeconomic stability is key to strengthen BoP.

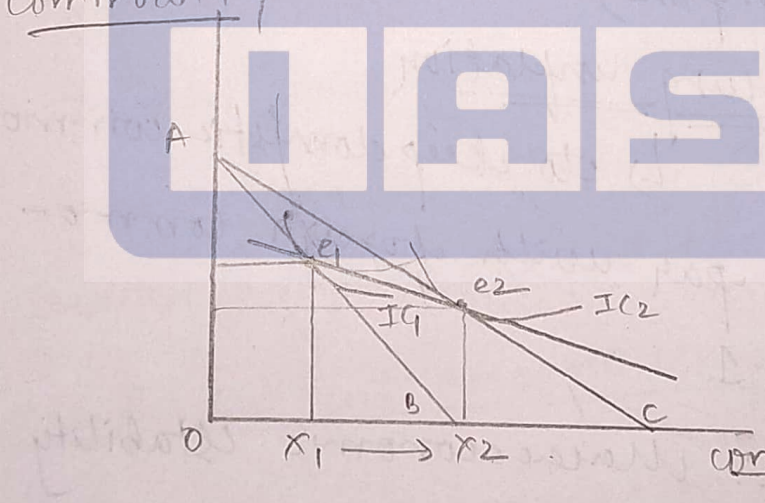
(b)

Ans

Price offer curve of price consumption curve reflects the price elasticity of demand for the particular commodity.

Illustration

Case - I Good X is normal, and there is fall in price of good 'X' (ie) $P_x \downarrow$.



if price offer curve is downward

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Slopping as in this case. reflects elastic demand.

Budget line $\Rightarrow P_x X + P_y Y = M$

P_y is constant,

and Y has fallen,

therefore $\boxed{P_y Y}$ has fallen.

if $P_y Y$ has fallen, then $\boxed{P_x X}$ must have risen.

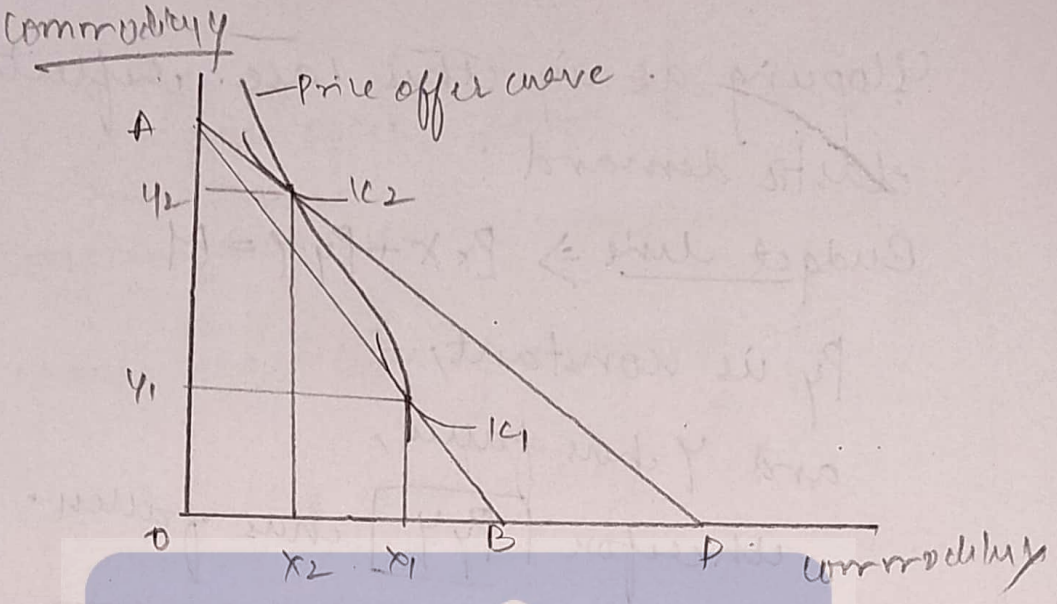
$\Rightarrow$ P_x falls and $P_x X$ ↑ this means that price elasticity is greater than 1, (i.e) elastic demand.

Case 2 Good X is normal and the price of X is fallen.

$\boxed{P_x \downarrow}$

$\Rightarrow$ if price offer curve is backward bending, then price elasticity

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is inelastic.

$P_x x + P_y y = M$, P_y is constant, but y has risen

$\therefore \Rightarrow P_y y$ has risen.

$\Rightarrow P_x$ of and $P_x x \downarrow$

This reflects that price elasticity of x is inelastic or less than 1.

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Q

Ans

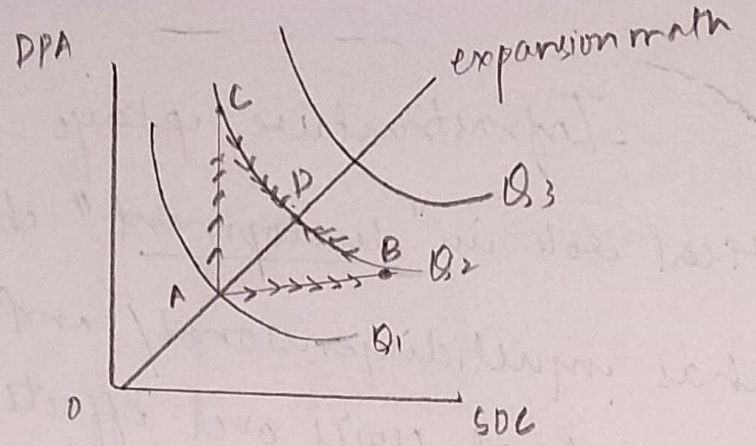
Infrastructure plays a critical role in "development" because it has multidimensional and multisectoral spill over effects.

⇒ Infrastructure forms the key component of "Social overhead capital (SOC)".

- As propounded by Hirschman in unbalanced growth theory, SOC is divergent economic activity that creates more externalities than it appropriates.
- it is an income inducing force and acts as stimulus to the "direct productive activities"

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C-AVZ-0-1



Infrastructural development takes economy through the path A → B → D. thus crowding in private investment.

⇒ Infrastructure consists a mix of public utilities, transport, energy and communication. It generally has long gestation period and cannot be imported.

□ Therefore, Rosenstein Rodan postulates that a Big push, in form of, infra-structural development must be given

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in order to boost growth and achieve economies of scale.

⇒ Infrastructural development increases the value of accelerator.

↳ it helps in reducing logistical costs of economic activities.

↳ Increasing productivity of investment in other sectors.

⇒ Infrastructure has spread effects. development

↳ creates employment opportunities.

↳ Improves connectivity, transport, ease of living, and ease of doing business. ∴ increases aggregate demand in the economy.

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⇒ Infrastructure also helps in balanced regional growth

↳ reduces poverty in rural areas.

↳ can be used as an instrument in indicative planning.

However, infrastructure improvement involves following challenges.

- ☐ high cost and expensive
- ☐ long gestation period.
- ☐ may lead to fiscal deficit
- ☐ reduces expenditure on welfare activities.

Infrastructure improvement shall be balanced with equal emphasis on social sector spending to maximize growth potentials.

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