In a market economy, the decisions and choices about resource allocation are left to market forces of demand and supply, and the working of the price mechanism. What producers will make and what consumers will buy are kept in balance by the price that producers will want for their output and the price that consumers are willing to pay.

In a planned economy, the decisions and choices about resource allocation are made by the Government. Money values are attached to resources and to goods and services, but it is the government that decides what resources should be used, how much should be paid for them, what goods should be made and what their price should be.

1) Operating an economy is so complex that inevitably some resources are used inefficiently.

2) Since no one in particular owns the resources, people have less incentive to employ them in their highest valued use.

3) Because the government is responsible for all production, the variety of products tends to be more limited than in a market economy.

4) Central plans reflect the preference of central planners rather than the preferences of the society.

5) Individuals have less personal freedom in making economic choices.

A.2 When price is not at the equilibrium point there is a state of disequilibrium in the economy. Here quantity demanded and supplied is not equal to each other, i.e. either the quantity demanded is more or less than the quantity supplied.

Both the cases of shortage and surplus are shown below:
At price P1, the suppliers want to produce quantities in excess of the quantity demanded at that price, as shown by the distance AB. The excess supply in the economy pushes the price level down until it shifts to equilibrium price.

The opposite will happen at price P0 where there is an excess demand over supply shown by the distance CD. The short supply in the economy pushes the price level up until it shifts to equilibrium price.

A.3 The consumer is said to be in equilibrium when the maximum possible satisfaction is obtained from the individual’s purchases, at the prices prevailing in the market and the amount of money the individual possesses for making purchases.

The consumer’s equilibrium can be demonstrated by means of Indifference Curve using the following diagram:

(i) AM is the consumer’s price line. Each point on the line represents a combination of quantities of products A and B which the consumer can buy at the prevailing prices, given the amount of money the individual has to spend on the two products. Hence the equilibrium must be on some point on this line.

(ii) The level of satisfaction increases as the individual moves from lower indifference curve to higher indifference curve i.e. the individual is at a lower level of satisfaction at the combinations represented by IC1 and at a higher level of satisfaction when on IC2 and so on.

(iii) IC3 is the highest indifference curve to which the individual can go, given the money and the prices of the goods in the market. The price line is tangent to the indifference curve at point P which is the point of maximum satisfaction because all other points on the curve are beyond the budget line.
(iv) Thus the consumer will be in equilibrium when the individual purchases OH quantities of product A and OJ quantities of product B.

b Explain with the help of diagrams income and substitution effect of a price rise for normal goods.

A.4 a Price Discrimination:
The term price discrimination refers to a situation in which a firm sells the same product at different prices in different markets.

Under the following conditions it is possible for a monopolist to keep his sub markets separate to successfully practice price discrimination:

(i) When consumers have certain preferences or prejudices:
When the customers have strong preferences and prejudices for certain brand names, labels, packages, settings/location of point of sales/service outlets and would not compromise for low prices in the cheaper markets, monopolists are encouraged to charge discriminating prices.

(ii) Nature of the goods:
When the nature of the good is such that it is possible for the monopolist to charge different prices. This happens particularly when the good in question is a direct service.

(iii) When consumers are separated by distance or tariff barriers:
When consumers are separated by distance or tariff barriers, the monopolist can charge different prices. A good may be sold at one location for Re. 1 and at another for Rs. 2 as long as the cost of transport or the tariff exceeds the difference in prices.

(iv) Government Regulations:
Price discrimination also occurs when the government rules and regulations permit. For instance, according to rules, electricity rates may be fixed at lower level for industrial purposes and higher for domestic uses.

(v) Ignorance:
Monopolists also take advantage of the ignorance of the customers and can charge higher prices from customers who are ignorant.

(vi) Same service for different purposes:
A monopolist, while rendering the same service to cater for different needs of his customers may charge discriminating prices. For example railways charge different rates for carrying coal, silk and fruit even though the same train carries them all.

(vii) Special orders:
When goods are being supplied to special orders, a monopolist can easily charge discriminating prices because in such cases, buyers cannot compare prices.

b Oligopoly:
A situation of imperfect competition in which an industry is dominated by small number of suppliers is called ‘Oligopoly’.

Characteristics of Oligopoly:
(i) In oligopoly market there are just a few producers in the market. E.g. petroleum market.

(ii) In oligopoly market product may be homogeneous or differentiated.
c Non-collusive oligopolies – kinked demand curve

Price cartel is formed in oligopoly but collusion of these cartel converted into price war among the oligopoly firms as there are inside competition among the oligopoly firms. Each firm’s decision about output level and price are affected by the rivalry firm's decision. This is best explained by the Sweezy Model or kinked demand curve model that are as follows:

Assumptions of kinked demand curve:

(i) There is an established or prevailing market price for the product of the oligopolistic industry.

(ii) Each seller’s attitude depends on the attitude of his rivals.

(iii) Any attempt by one seller to increase sales by reducing price of his product will trigger other firms will also follow his move and thereby starting Price War.

(iv) If one seller raises price of his product other firms may not follow his price rise policy.

If a rivalry firm increases its price others oligopoly firms in the industry will not change its price and the rivalry firm would lose most of its customer share. In this case the demand for the products becomes elastic. On the other side when an oligopoly firm decreases its price others oligopoly firms will also reduce the prices and will match the price cut, this will not increase its share of the market by reducing its price. The demand become inelastic. Elastic and inelastic demand joins at point K(kinked) to form a kink. Thus there is a strong compulsion from the oligopoly not to change the prevailing price but rather to compete for a greater share of the market on the basis of quality, product design, advertisement and service. Hence there will be price and output stability with the cost changes for the oligopoly firms, which changes its MC curve not affecting output and price.

A.5 a The government can influence the level of private investment in several ways:

(i) Control interest rates: By keeping interest rates low, for example, the government might encourage a higher volume of investments, whereas by allowing interest rates to rise, the government would probably cause the volume of investment to fall. Government can influence interest rates.
(ii) Provide direct encouragement to investing firms: By offering investment grants, perhaps directed at particular regions, by lowering the cost of investment i.e. cost of doing business, by improving the rule of law, by providing tax incentives etc.

(iii) Seek to stimulate business confidence: By developing and announcing an economic policy for continued growth which should be consistent with the stated goals. Frequent and sudden changes in economic policy results in loss of business confidence.

(iv) Encourage technological developments: By financing research schemes of its own as well as those of private firms. In the long run, investment in education might be significant for the strength of innovative research and development by the country’s industries.

(v) Influencing the volume of consumption: Sometimes the government indirectly influence the level of investment, for instance a policy to control the growth in the money supply, would help in credit control and would in turn affect consumer spending, especially in consumer durable goods. Changes in consumption affects investment levels, with the influence of the accelerator.

(vi) Government spending: Higher government spending in infrastructure cerates demand which stimulates investment by the private sector.

A.6 a  Accelerator

It is the ratio between the change in induced investment and a change in national income occurring through a change in consumption.

\[ W = \frac{\Delta K}{\Delta Y} \]

b  Limitations of accelerator principle

Following are some of the limitations of the accelerator principle:

(i) Temporary change in demand:
It is applicable only when there is a permanent change in demand. When the rise in demand is temporary, the entrepreneurs instead of increasing their investment may only employ the labourers to work over-time to meet the additional demand. Thus, in case of temporary change in demand, the principle of accelerator does not operate.

(ii) Business expectations:
Entrepreneurs make investment keeping in view the expected rate of profitability. So business expectations play a vital role in determining the induced investment rather than the current changes in the demand for consumer goods.

(iii) Concept of capital-output ratio:
It explains the concept of capital-output ratio for the whole economy. However, in reality the capital-output ratio cannot be generated for the whole economy. This ratio varies from one industry to another. Hence, the concept of accelerator is confined to an industry rather than being applicable to the whole economy.

(iv) Constant aggregate demand:
Increase in demand for a particular consumer good may lead to a reduction in demand for a substitute. Therefore, an increase in investment in one industry may reduce the investment in another industry and hence the aggregate demand for whole economy may remain constant. In this case, the aggregate induced investment will not change and hence the concept of accelerator would not apply.

(v) Non-availability of financial resources:
The accelerator principle emphasizes that induced consumption results in an increase in induced investment. However, due to financial constraints, it may not be possible to increase the investment level. Under such circumstances, the accelerator theory would not work despite having induced consumption.
(vi) **Difference in durability of machinery:**
It assumes that the machines used for production purposes have equal life-span and durability. Such an assumption is not practical.

(vii) **Lack of productive capacity:**
The principle of accelerator states that induced consumption results in an increase in induced investment. But in cases where the capital goods industries are already operating at full capacity and the production of additional machines is not possible i.e. in the short-run, the theory of accelerator ceases to apply.

(viii) **Long run investment projects:**
Autonomous investment takes place in long term projects which is known as the income inelastic investment. In the case of these projects, the concept of induced investment becomes irrelevant because induced investment is income elastic investment. Thus, the concept of accelerator does not apply to long term projects.

A.7  

**b**  

**Difference between a fiscal deficit and the national debt:**

**Fiscal deficit:**
The fiscal deficit is the annual amount by which government expenditure exceeds government tax receipts and therefore represents the annual borrowing requirement, whereas;

**National debt:**
National debt is the amount of debt owed by the central government of a country to its various creditors. Creditors may be nationals of the country for example, investors in governments loan stock or foreign nationals like foreign banks, IMF etc.

**Relationship between the two:**
There is a dynamic relationship between fiscal deficit and the national debt which can be summarized as under:

(i) The government has to pay interest on the national debt each year and these interest payments are part of this year’s government expenditure and consequently have the effect of raising the fiscal deficit.

(ii) In turn the fiscal deficit when it is financed by increased government borrowing will have the effect of raising the national debt.

(iii) If the government manages to have a fiscal surplus it could use the excess money to repay part of the national debt.

**Direct effect of rise in interest rates on the fiscal deficit and the national debt:**
The direct effect of a rise in interest rates is a rise in the cost of current government borrowing and therefore, an increase in the fiscal deficit. In addition, it raises the cost of financing the national debt.

**b**  

**Analyse the effect of imposition / increase of indirect taxes on producers and consumers and its relationship with the elasticities of demand and supply.**

An indirect tax increases the cost of products. Its effect on the market place depends upon the relative elasticities of demand and supply and the extent of the tax charge. The market would either pass on the cost to consumers or to bear the affect by way of a reduction in profit. At first consideration it might appear that a simple solution of passing the entire amount of tax on to the consumer would be considered to be appropriate. The following diagram indicates the effects of indirect taxes on elasticity of demand and supply.
A.8 a The motives for retaining money in liquid form are:

**Transactions motive** –
Individuals need money to meet their day-to-day requirements of purchases of goods and services. The need to hold money for transactions arises because the payments and receipts of individuals are not exactly synchronised. The liquidity preference or transactions demand for money will increase either by an increase in the real national income or an increase in the general price level or any combination of the two.

**Precautionary motive** –
Individuals keep money in hand or with banks as a precautionary measure to meet any unforeseen fluctuations in receipts and payments. The precautionary demand for money arises due to uncertainty regarding the timing and size of payments and receipts. The higher the level of national income, the larger amounts of money balances that would be needed for precautionary purposes, reflecting higher liquidity preference.

**Speculative motive** –
The holding of money has an opportunity cost in the form of income foregone by not using the money to purchase an income bearing asset e.g. a bond. When interest rates are high, individuals will hold lesser amounts for speculative purposes and therefore have low liquidity preference. When the interest rates tend to be low, individuals will retain large amounts in anticipation of increase in interest rates and would have high liquidity preference.

A.9 b Floating exchange rate
Floating exchange rate is the rate set by the unhindered forces of demand and supply of the currency.

**Fixed exchange rate**
Fixed exchange rate is the rate set at a fixed parity against one or more foreign currencies. In this case the government agrees to buy or sell at this rate to stop fluctuations.

**Advantages of floating exchange rates**

(i) The need for government intervention in the foreign exchange markets is eliminated.
(ii) It helps to correct balance of payments disequilibrium.
(iii) Frees the policy instruments of government to concentrate on internal issues such as unemployment and inflation.
(iv) Acts as a shock absorber. Variations in the rates of exchange act as a check against invasion of the inflationary and deflationary forces.

**Advantages of fixed exchange rates**

(i) Avoids damaging speculation effect against the local currency.
(ii) Promotes trade as importers and exporters are protected from exchange rate risks.
(iii) Government has to pursue responsible economic policies domestically because excess aggregate demand and inflation would make it very difficult to support the currency in the long term.

b Identify the reasons why a government may want to influence exchange rate.

A government may want to influence exchange rates in order to achieve the following objectives:

(i) Stabilise the domestic currency against the pressures of short-term speculation.
(ii) Stimulate demand for exports or to restrain imports.
A.10 a Capital market is a term which describes the institutions which provide long-term and medium-term finances, and the financial instruments that are traded in these markets. Both private firms and the government place and raise funds in the capital markets.

b An active stock exchange:

(i) Facilitates large firms and governments in raising long-term capital by providing a market place for both the borrowers and investors in which they can interact.

(ii) Enforces a regulatory environment so that investors have the assurance that companies listed on the exchange and the traders would comply with the rules and regulation.

(iii) Index of share prices listed on the stock exchange acts as a barometer of the state of investor confidence in the country’s economy. It helps the government to assess the impact of its policies, on the economy.

(iv) Prices of quoted/listed securities are readily available and the investors can therefore make informed decisions for purchase and sale of their shareholdings.

(v) Ensures liquidity of the investments.

c Following factors are responsible for fluctuations in the share prices of companies:

(i) Company’s profitability

(ii) Rate of dividends

(iii) Important transactions like takeover bids, signing of large contracts etc.

(iv) Changes in the strategies and corporate policies

(v) Monetary and credit policies in the country

(vi) Inflation and deflation in the country

(vii) Taxation policies of the government

(viii) Expectations of economic upturns/downturns

(ix) Import and export policies

(x) Conditions prevailing and emerging in the country e.g. civil unrest and commotion, imminent conflicts with other countries, elections, international incidents, floods, earthquakes, etc.