

Answers to REC–DS2/Set-1

1. (c) Both statements 1 and 2 are true
2. (d) Sales + Change in stock
3. (d) The general price level is fixed in the short run
4. (c) The value of the rupee against one dollar must be rising before the intervention.
5. (c) Store of value
6. (a) 324, 40000, 4000, 36000

Working Note:

Legal Reserve Ratio = 10% or 0.1 and Money Multiplier = $1/\text{LRR} = 1/0.1 = 10$

(i) Cash Reserves = $3240 \times 10/100 = 324$

(ii) Deposits = $4000 \times 10 = 40000$

(iii) Cash Reserves = $400 \times 10 = 4000$

(iv) Loans = $3600 \times 10 = 36000$

7. (c) decrease tax rate
8. (c) (i) and (ii)
9. (a) ₹ 100 crore; ₹ 640 crore

Working Note:

$$C = 100 + 0.80 Y$$

$$C = 100 + 0.80 \times 800$$

$$C = 100 + 640$$

10. (a) Short-term debt
11. The transactions carried by monetary authority of a country, which cause changes in official reserves, are termed as official reserve transactions (ORT). These transactions are carried through purchase or sale of currency in the exchange market for foreign currencies or other assets. The reserves are drawn by selling foreign currencies in exchange market during deficit and foreign currencies are purchased during surplus. When the official reserves increase or decrease, it is called overall balance of payments surplus or deficit respectively.

Importance of ORT in balance of payments:

- (a) Purchase of a country's own currency is a credit item in the balance of payments; whereas, sale of the currency is a debit item.
- (b) It helps to adjust the deficit and surplus in balance of payments.

12. (A) Domestic Income (NDP_{FC}) = (i) – (ii) – [(iv) – (iii)] – (v)

$$= 60,000 - 4,500 - [3,230 - 1,520] - (-4,010)$$
$$= 60,000 - 4,500 - 1,710 + 4,010$$
$$= ₹ 57,800 \text{ crores}$$

Or

- (B) (i) **Compensation to Employees:** The amount earned by employees from their employer, whether in cash or in kind or through any other social security scheme is known as compensation to employees.
- (ii) **Factor Income:** It is the income received by the owners of factors of production in the form of rent, wages, interest and profit for the services rendered in the production process.
- (iii) **Mixed Income:** It refers to the income of self-employed persons using their own land, labour, capital and entrepreneurship in their household enterprises.

13. Given that, $C = 200 + 0.5Y$, $I = 400$ and $Y = 1,500$

At equilibrium level, $AD = AS$

or, $Y = C + I$

$$Y = (200 + 0.5Y) + 400$$

$$Y - 0.5Y = 600$$

$$Y = \frac{600}{0.5} = ₹ 1,200 \text{ crore}$$

The given income ₹ 1,500 crore is greater than equilibrium level of income ₹ 1,200 crore. Therefore, the economy is not in equilibrium.

14. (A) In an economy, if aggregate demand (AD) is greater than aggregate supply (AS), it implies that buyers now plan to purchase more goods and services than producers are planning to supply. Producers keep ready stock in the form of 'inventories'. When $AD > AS$, this implies that buyers are buying

faster than what the sellers had expected. Thus the inventories start falling and fall below the desired level. So to bring back the inventories at their desired level, producers produce more, which raises the income level, which keeps on going up, till $AD = AS$, once again.

Or

(B) It is true that a cut in repo rate is expected to lead to a cut in market rate of interest. Accordingly, cost of investment would fall and investment would increase. But, sometimes RBI does not appreciate lowering repo rate. This is because a cut in repo rate allows commercial banks to build up their cash reserves and increase their capacity to create credit. If the supply of credit increases, the rate of inflation starts multiplying. Thus, RBI is reluctant to lower repo rate in a situation when the existing rate of inflation is high and is expected to rise further.

15. The rate at which commercial banks can borrow money from RBI, when they run short of reserves, is called bank rate. When the Central Bank increases the bank rate, it increases the cost of borrowing and hence, discourages the borrowers from taking a loan. Due to this, the process of credit creation and flow of money also reduces. On the other hand, when the Central Bank decreases the bank rate, it encourages the borrowers to take more and more loan. A high demand of loan increases the credit multiplier and credit creation process of the commercial banks.

16. (A) (i) Primary deficit = Fiscal deficit – Interest payments

$$12,000 = \text{Fiscal deficit} - 7,000$$

$$\text{Fiscal deficit} = 12,000 + 7,000$$

$$= ₹ 19,000 \text{ crores}$$

(ii) Total borrowing requirements of the government are estimated at ₹ 2,70,000 crores. It means,

$$\text{Fiscal deficit} = 2,70,000$$

$$\text{Primary deficit} = \text{Fiscal deficit} - \text{Interest payments}$$

$$= 2,70,000 - 1,40,000$$

$$= ₹ 1,30,000 \text{ crores}$$

(B) Borrowings lead to increase in liabilities of the government, hence, it is a capital receipt.

Or

- (C) Revenue expenditure is the expenditure made by the government that neither creates any asset nor reduces any liability, whereas the capital expenditure is the expenditure incurred by the government that either creates assets or reduces liabilities.

Example of Revenue Expenditure: Expenditure on salaries, interest, are examples of revenue expenditure.

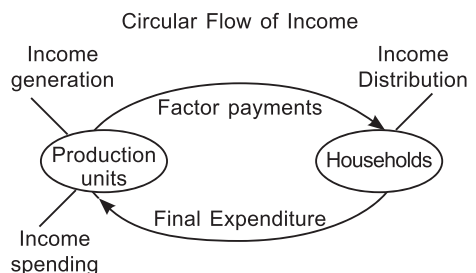
Example of Capital Expenditure: Expenditure on land, machinery etc. are examples of capital expenditure.

- (D) The excess of the government's revenue expenditure over the revenue receipts is called revenue deficit. Given the same level of the fiscal deficit, a higher revenue deficit is worse than a lower one. High revenue deficit implies that the government should follow contractionary fiscal policy, that is, increase tax and/or reduce spending.

In a less developed countries, it is difficult to force people to pay higher taxes or to cut expenditure on development activities. Thus, the government usually finance its revenue deficit through borrowings. A revenue deficit implies a repayment burden in the future, not matched by any benefits via investment. It leads to rise in the prices and hampers the progress of the economy.

17. (a) (i) Profits earned by a foreign bank from its branches in India will not be included in the estimation of domestic factor income of India because it is the factor income of a foreign country or it is the income of non-residents in India.
- (ii) Scholarships given by the Government of India will not be included in the estimation of domestic factor income of India because it is a transfer payment and does not contribute to the flow of goods and services.

- (b) The given diagram of circular flow of income depicts the three phases of the flow of income, namely, income generation phase, income distribution phase and income spending phase.



- (i) Production phase, *i.e.*, income generation phase leads to production of goods and services in an economy.
- (ii) Income Distribution phase leads to generation of factor income in the form of rent, wages, interest and profit.
- (iii) Expenditure phase, *i.e.*, income spending or disposition phase deals with the spending of income in terms of consumption (C) and investment expenditure (I).

All the above three processes, *i.e.*, production, distribution and spending go on simultaneously.

- 18. (d) Promoting trade by big rural merchants
- 19. (c) Attract foreign investors
- 20. (c) (i) and (iii)
- 21. (a) Call centres
- 22. (b) Both Assertion (A) and Reason (R) are true but Reason (R) is not the correct explanation of Assertion (A)
- 23. (d) (i), (ii) and (iii)
- 24. (c) Great Leap Forward
- 25. (c) G-7
- 26. (c) Both statements 1 and 2 are true
- 27. (b) B – (ii)
- 28. (A) Some of India's most crucial challenges at the time of independence were:
 - Increased dependence of population on agriculture
 - Traditional methods of cultivation
 - Destruction of Indian handicrafts industries
 - High level of unemployment
 - High infant mortality rate, low life expectancy and literacy rate
 - Widespread mass poverty (any three)

Or

- (B) The domestic industries of India were not in a position to compete against the goods produced by more developed economies. So, the policy of import substitution helped in protecting them in two ways:

- **Tariffs:** Heavy duty or tariff was imposed on imported goods in order to make them more expensive and to discourage their use.
- **Quotas:** Quotas refer to fixing the maximum limit on the imports of a commodity by a domestic producer.

The tariff on imported goods and fixation of quotas helped in restricting the level of imports. As a result, the domestic firms could expand without fear of competition from the foreign market.

29. Investment in human capital contributes to the growth of economy. It can be justified with the following points.
- (a) **Higher production and productivity:** The contribution of an educated person to the output or production is more than that of an illiterate person. Similarly, a healthy person also contributes to economic growth by providing un-interrupted labour supply for a longer period of time.
 - (b) **Promotes inventions, innovations and technological improvements:** Human capital formation not only increases the productivity of human resources but also stimulates innovations and creates ability to absorb new technologies. Education provides knowledge to understand changes in society and scientific advancements, thus, facilitate inventions and innovations. Similarly, the availability of educated labour force facilitates adaption to new technologies.
30. Till the late 1970s, all the three countries were maintaining the same level of low development. Over the last three decades, the three countries have taken different levels of development.
- India has performed moderately over the years. Majority of its people still depend on agriculture. Infrastructure is lacking and more than one fourth of its population live below poverty line.
 - Pakistan performed low because of political instability, overdependence on remittances and foreign aid along with volatile performance of agriculture.
 - China has used the market system to succeed in raising the rate of growth in economy with stress on alleviation of poverty.

31. (A) (i) True, expenditure on migration is a source of human capital formation as enhanced earning in the migrated place is more than the increase in costs due to migration. This lead to capital formation through fuller utilisation of skills.
- (ii) False, as elementary education covers only primary level of education. It typically covers the initial years of formal schooling, which includes primary levels. It is for the duration of 8 years. The children under elementary schooling cater to age group of 6-13 years from classes I-VIII.

Or

(B) Yes, it is necessary to generate employment in the formal sector rather than in the informal sector because those who work in the informal sector do not get any regular income and do not get protection from the government. Workers are dismissed without any compensation. Technology used is outdated and they also do not maintain any accounts. Workers live in slums or badly built houses.

Those who work in the formal sector, on the other hand, earn more than those in the informal sector and also enjoy social benefits. It is thus, necessary to generate more employment in the formal sector.

32. The situation depicted in the given image is unemployment. Unemployment is a social problem. The important social consequences of unemployment are as under:
- (a) **Low quality of life:** It lowers the quality of life, implying the state of perpetual sufferings.
 - (b) **Greater inequality:** It extends the inequality in the distribution of income and wealth.
 - (c) **Social unrest:** Terrorism may be motivated by several other factors, but the contribution of self-desperation is by no means less significant.
 - (d) **Class struggle:** It divides the society into have and have-nots. There is a class conflict that compound the social unrest. (any three)

33. (A) Following observations explain the reversal of growth process under the British Raj in India:

- (i) **Agriculture:** Prior to the British Raj, cultivators enjoyed the ownership rights and were to pay a reasonable amount of land revenue directly to the king. This process was reversed by the introduction of British Raj. This led to exploitation of the farmers and truncated the growth process of agriculture.
- (ii) **Industry:** Industry was dominated by handicrafts, and it enjoyed worldwide reputation of producing quality products like 'Deccai Muslin'. It was destroyed through discriminatory tariff policy.
- (iii) **Foreign Trade:** Prior to the British Raj, exports consisted largely of finished products and imports were largely of bullion (gold and silver). During the British Raj, India became net exporter of raw material and importer of finished goods.

Thus, the colonial policy of the British government almost reversed the composition or structure of output as well as the composition of exports and imports. This led to reversal of the growth process. Consequently, the pace of growth was severely hit.

(B) India opted for economic planning as a means for economic development due to following reasons:

- **Limited resources:** The resources in India for economic development were limited and it was essential to utilise them in an effective manner for growth.
- **Balanced regional development:** Economic planning was needed to develop the regions of the country which were backward economically. It was necessary for removal of regional disparities.
- **Social justice:** Economic planning was necessary to ensure social justice in the economy in such a way that inequality of income and wealth between rich and poor is reduced. *(or any other relevant point)*

Or

(C) It is true that large-scale industry is not a substitute of small-scale industry in the Indian economy. The reasons are as follows:

- (i) Owing to massive poverty in the country, India must focus on employment generation. SSIs are more labour-intensive and therefore, must be accorded a priority over the large-scale industries.

- (ii) India places high priority on growth with social justice. Doubtless, social justice (equity) is better promoted through SSIs, rather than large-scale industry.
 - (iii) Indian economy shows huge regional lopsidedness. It can be best addressed through SSIs.
- (D) The following points will highlight the reasons that make India a favourite outsourcing destination:
- (i) Wage rates in India are less as compared to other developed nations, and it makes MNCs invest in Indian workers and shift a part of their business to India.
 - (ii) Indians are educated and can be easily trained, but due to the lack of job opportunities, job training costs will be low.
 - (iii) India is an emerging market for goods and services, as the cost of production is cut by half if it is produced in India; therefore, it makes sense to invest in India.
 - (iv) India offers a stable political environment suitable for setting up businesses.
 - (v) India has been developing the infrastructure section for the last 10-20 years, and connectivity has become much improved; this has helped MNCs in reducing the cost of production.
 - (vi) India has abundant natural resources, which make for a steady source of raw materials to ensure the proper functioning of MNCs.

(or any other relevant point)

34. (a) The concept of sustainable development was emphasised by the United Nations Conference on Environment and Development (UNCED), which defined it as: 'Development that meets the need of the present generation without compromising the ability of the future generation to meet their own needs'.
- (b) Sustainable development aims at decreasing the absolute poverty of the poor by providing lasting and secure livelihoods that minimise resource depletion, environmental degradation, cultural disruption and social instability. The Brundtland Commission emphasises on protecting the future generation.