1a. What is Consumer Price Index (CPI) ?

Answer:

The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of consumer goods and services.

1b. What is difference between CPI and GDP deflator?

Answer:

- CPI include anything bought by consumer both domestic and foreign produced goods **while** GDP deflator include only domestic goods and not any goods imported.
- CPI is measure of price of goods only bought by consumers **while** GDP deflator is a measure of price of all goods and services.

1c. Does consumer price index overstate the true rate of inflation?

Answer:

CPI overstates the rate of inflation because of the following reasons:

- Error in data collection and estimation. Inflation indicates are calculated by statisticians based on sample of goods and services. The issue is whether that sample and sampling technique used provide accurate representation of consumption behaviour.
- Quality bias. Some price increases may as much reflect improvement in quality and variety of products than inflation. As a result of ignoring quality improvements, the CPI overstates the true extent of inflation.
- Substitution bias. CPI holds over time same kind and amount of goods and services in a typical basket. Since price of these goods and services may increase indifferently, a typical family responds to these changes by switching from more expensive to cheaper products. Thus, CPI overstates the true extent of inflation.
- New goods bias. New goods and services provide consumers variety and choice , leading probably to less costly alternatives, but this cost saving would not be reflected in the CPI.

1d. Which is better measure of inflation between CPI and GDP Deflator?

Answer:

GDP Deflator is the better measure of inflation compared to CPI.

Reasons:

- GDP Deflator uses changing quantities ie current year quantities which reflects the current situation of the economy different from CPI which uses base year quantities
- GDP deflator focuses on the goods produced in the economy rather than CPI which focuses on good and services that are consumed
- CPI includes all goods consumed irrespective of where they are produced while GDP deflator includes only the goods produced within the economy making it more relevantbto the econom

2a. With the help of a diagram, explain the Income-Expenditure Model.

<u>Answer:</u>

The Income-Expenditure Model of Economics was developed by John Maynard Keynes to explain fluctuations in production of goods, services and spending. The model basically states that we produce as many goods as we sell on the market and fluctuations in production and expenditure are tied to keep an economy stable. The model focuses on the total amount of spending in the economy with no explicit mention of aggregate supply or the price level.

From the graph, the vertical line refers to the quantity of output that economy can produce with full employment of it's labour and physical capital. The 45 degree line shows all points where aggregate expenditure and output are equal. The intersection is an equilibrium where aggregate expenditure is equal to output.

2b. The difference between Planned Expenditure and Actual Expenditure

Answer:

Planned expenditure refers to the amount that was intended or expected to be spent during a certain period of time by an entity where as, planned expenditure, P.E=C+I+G+NX **while** Actual Expenditure is the amount that is actually spent that is; the actual monetary amount spent by an entity in a given time period.

The difference between them is the unplanned inventory investment which can cause the actual expenditure to be either higher or lower.

2c. Explain goods market and the goods market equilibrium.

Answer:

Goods market refers to the trade market in all goods and services that the economy produce at a given period of time.

Goods market equilibrium is a situation where the aggregate demand is equal to the aggregate supply.

The goods market is in equilibrium when current output (Y) is equal to aggregate expenditure (AE). Since AE = C + I + G then goods market equilibrium is attained when Y = C + I + G.

2d. How is the equilibrium level of national income/output determined?

Answer:

According to Keynesian Theory, equilibrium condition is generally stated in terms of Aggregate Demand and Aggregate Supply.

An economy is said to be at equilibrium when AD is equal to AS ie; AD=AS

Aggregate Demand- Is the sum of total goods and services that are demanded in an economy over a period of time and thus AD is defined by planned total expenditure in an economy level.

Aggregate Supply- Is the total output of goods and services of national income

Aggregate Demand= planned expenditure= AE

Aggregate Supply= Aggregate Output =Y

Whereas:

AE= C + I + G (Considering a closed economy)

Y= C+S+T

It determined graphically by graphing Aggregate expenditure against national income and output and point where the Aggregate expenditure (AE) meets/intersects the National Output/Income (Y) it is where the equilibrium output is.

Also determined algebraically by equating

$$Y = AE = C + I + G.$$