Module 3

1.What is Pricing?

Pricing refers to the process of determining how much a company will charge customers for its products or services. It involves setting a price point that balances:

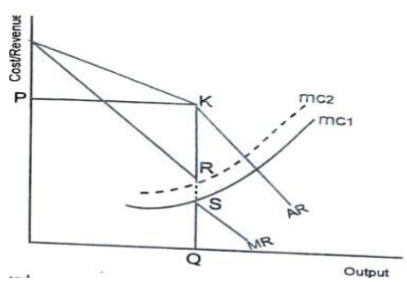
- Costs
- Value
- Market Demand
- Competition
- Business Goals

2.Explain kinked demand curve

The kinked demand curve model, developed by Paul M. Sweezy, explains price rigidity in oligopolistic markets. In this model :

- The demand curve has a "kink" at the prevailing market price.
- Above the kink, demand is elastic. If a firm raises its price, others will not follow, leading to a large fall in demand.
- Below the kink, demand is inelastic. If a firm lowers its price, others will also cut prices, leading to only a small gain in customers.

This behavior leads to a discontinuous MR curve, where a change in marginal cost (MC) within the discontinuous region does not affect the equilibrium price or output. Thus, firms tend to stick to existing prices, explaining price rigidity in oligopoly.



3.Why a firm under perfect competition is called a price taker?

A firm under perfect competition is called a price taker because:

- Large number of sellers: Each firm is small and contributes a tiny fraction to total market supply, so it cannot influence the market price.
- Homogeneous products: All firms sell identical products, so buyers have no reason to pay more to one seller over another.
- Free entry and exit: New firms can enter or leave the market freely, which keeps prices at a competitive level set by market demand and supply.

Thus, firms must accept the prevailing market price and can only decide how much to produce, not what price to charge.

4.Explain equilibrium of a firm under monopolistic competition

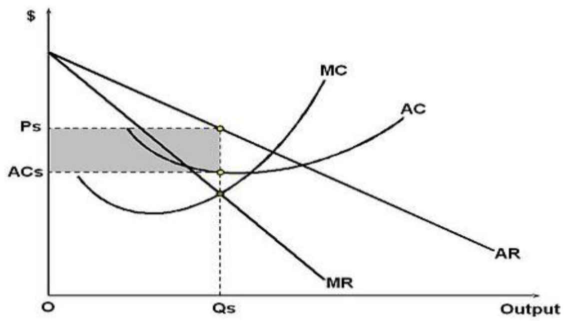
Equilibrium of a Firm under Monopolistic Competition

In monopolistic competition, firms operate in a market where there are a large number of buyers and sellers, but the products sold by each firm are differentiated in some way (e.g., in terms of quality, features, brand, etc.). This gives firms some degree of market power, allowing them to set prices higher than marginal cost. The equilibrium of a firm under monopolistic competition can be understood in both the short run and the long run.

1. Short-Run Equilibrium(Supernormal profit)

In the short run, a firm in monopolistic competition behaves similarly to a monopolist. The equilibrium is determined by the intersection of the Marginal Revenue (MR) and Marginal Cost (MC) curves. The following key points explain the short-run equilibrium:

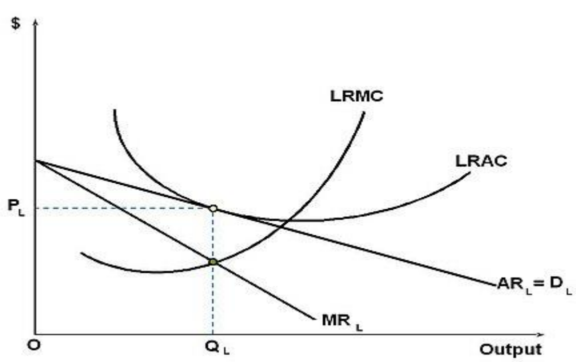
- Demand Curve (AR Curve): The firm's demand curve is downward sloping because each product is differentiated, meaning it has some degree of monopoly power. The price decreases as the firm sells more units.
- Profit Maximization: The firm maximizes profit by producing at the output level where MR = MC. The price charged is determined by the demand curve at that level of output.
- Profit or Loss: In the short run, firms can earn supernormal profits, break even, or incur losses:
    - Supernormal Profit: If the price (AR) is higher than the average cost (AC) at the equilibrium output, the firm earns supernormal profits.
    - Normal Profit: If AR equals AC, the firm earns normal profit.
    - Loss: If AR is lower than AC, the firm incurs losses.



2. Long-Run Equilibrium

In the long run, firms can enter or exit the market based on the profits or losses being made. The dynamics of entry and exit lead to a new equilibrium:

- Entry of New Firms: If firms in the market are earning supernormal profits, new firms are attracted to the market. As new firms enter, the demand for each existing firm's product decreases, causing their demand curve to shift leftward.
- Exit of Firms: If firms are incurring losses, some firms will exit the market. This reduces the competition, allowing the remaining firms to regain demand and profitability.
- Normal Profit: The entry and exit of firms continue until firms earn normal profit in the long run, which occurs when price (AR) equals average cost (AC) at the equilibrium output. At this point, firms produce at the level where MC = MR, and there is no incentive for new firms to enter or exit the market.



Key Features of Equilibrium under Monopolistic Competition:

- **Price and Output**: Firms charge a price above marginal cost, unlike in perfect competition where price equals marginal cost.
- **Product Differentiation**: Product differentiation allows firms to have some monopoly power but results in competition as other firms offer close substitutes.
- **Free Entry and Exit**: The freedom of entry and exit ensures that firms will only earn normal profits in the long run.

5.Why price is rigid under oligopoly?

Price remains rigid under oligopoly mainly due to mutual interdependence among firms. Each firm is cautious about changing its price because competitors are likely to react.

🔷 1. Kinked Demand Curve Theory

If a firm raises its price, competitors won't follow, leading to a loss in customers. If it lowers the price, competitors match the cut, causing a price war. So, firms prefer to keep prices stable.

🔷 2. Fear of Price War

Any price cut can trigger a chain reaction among rivals, reducing profits for all. Hence, firms avoid changing prices frequently.

Module 4

1. Describe the fiscal policy measures to control an inflationary situation.(3 Marks)
2. What is Inflation? Explain different types of inflation and its control measures.Are the monetary or fiscal measures more effective in controlling inflation? (10 Marks)
3. Explain the monetary policy measures to control inflation.(7 Marks)
4. What are the different methods used to control Inflation? (7 Marks)
5. What is monetary policy? What are the monetary policy measures? (7 Marks)
6. Differentiate between GDP and GNP.(3 Marks)
7. How is GDP calculated? (3 Marks)
8. Distinguish between final goods and intermediate goods(3 Marks)

9. Explain circular flow of income in a four-sector economy.(7 Marks)
10. Explain circular flow of income in three-sector and four-sector models with a neat diagram. (10 Marks)
11. Explain circular flow of income in two-sector and four-sector models. (7 Marks)
12. What are government securities?(3 Marks)
13. Write notes on the following:(7 Marks)
    i) NIFTY and SENSEX
    ii) Demat and Trading Account
    iii) Bank Rate
    iv) CRR and SLR
14. Write a note on the following:(3 Marks)
    i) Stock Index
    ii) Demat Account and Trading Account
    iii) Bond and Share
15. What is a Trading Account?(3 Marks)
16. Distinguish between the Money Market and the Capital Market.(3 Marks) (7 Marks)
17. Discuss the sources of business financing.(7 Marks)
18. Estimate GDPmp, GNPmp, and National Income.

Item	Amount (in ₹000 Crores)
Private Consumption Expenditure	2000
Government Consumption	500
Investment	800
Net Exports	700
NFIA	-300
Depreciation	400
Net Indirect Tax	300

19. Estimate NNP, NDP, GDP, and GNP.

Item	Amount (₹ Crores)
National Income	2000
Depreciation	350
NFIA	-480
Indirect Taxes	350

20. Estimate NDP and NNP (Income Method).

Item	Amount (₹ Crores)
Wages & Salaries	800
Rent	300
Interest	400
Profit	400
Net Indirect Tax	400
NFIA	100
Depreciation	200

21. Estimate GNP, NNP, and National Income.

Item	Amount (₹ in 100 billion)
GDPmp	5000
NFIA	50
Indirect Tax	70
Subsidies	20
Depreciation	30

Answers

1. These are the measures taken by the government to control the aggregate demand in the economy. The main instruments of fiscal policy are i) public revenue ii)Public expenditure iii) Public borrowing

i) Public revenue - The main source of public revenue is tax. When there is inflation the government want to reduce the total spending in the economy and hence tax is increased. Increase in direct taxes decreases the disposable income of the people and hence they spend less money.

ii) Public expenditure - During inflation the government cut down its expenditure on developmental activities and welfare programmes. This reduces government demand for goods and services as well as private income. When the government spend less money, income of the individuals decreases. Hence aggregate demand decreases

iii) Public borrowing - When there is inflation the government will delay the repayment of public debt. At the same time the government should borrow more money from the public.

2. Inflation is a situation in which there is a persistent rise in the general price level. In other words it is a situation in which there is an upward movement in the average level of prices. According to Coulson it is a situation in which "too much money chasing too few goods”.

Types

(a) Creeping Inflation: When the rise in prices is very slow, that is less than 3% per annum, it is called creeping inflation. It is mild inflation and it is considered as good for economic growth.

(b)Walking Inflation: When prices rise moderately and the annual inflation rate is 3% to 10%. it is called walking inflation. Inflation at this rate is a warning signal for the government.

(c) Running Inflation: When prices rise rapidly and the rate of increase is 10% to 20% per annum, it is called running inflation. Its control requires strong monetary and fiscal measures and it is a dangerous situation.

(d) Galloping or Hyperinflation: When price rises between 20% to 100% per annum or even more, it is called galloping or hyperinflation. Such a situation brings a total collapse of the monetary system because of continuous fall in purchasing power of money

Sure! Here's a neatly formatted version that you can directly copy and paste into Microsoft Word:

Control Measures for Inflation

Inflation can be controlled using three main types of measures:

1. Monetary Policy Measures

These are measures adopted by the Central Bank (e.g., RBI) to control credit and money supply in the economy.

A. Quantitative Credit Control Measures

1. Bank Rate Policy
    a. The bank rate is the rate at which the central bank lends to commercial banks.
    b. During inflation, the central bank increases the bank rate, making borrowing more expensive.
    c. This reduces credit availability and lowers spending.

        d. Known as Dear Money Policy.
2. Reserve Ratio
    a. Cash Reserve Ratio (CRR):

Banks are required to keep a percentage of deposits with the central bank. Increasing CRR reduces lending capacity.

    b. Statutory Liquidity Ratio (SLR):

Banks must maintain a portion of deposits in safe assets like cash, gold, or government securities. Increasing SLR reduces funds available for lending.

3. Open Market Operations (OMO)
    a. The central bank sells government securities to absorb excess liquidity from the economy, reducing credit creation.

B. Selective (Qualitative) Credit Control Measures

1. Margin Requirements
    a. It refers to the difference between the loan amount and the market value of the security.
    b. Higher margins reduce borrowing and limit speculative investments.
2. Regulation of Consumer Credit
    a. Central bank controls terms of consumer loans (e.g., down payments, repayment period) to restrict unnecessary borrowing.
3. Moral Suasion
    a. Informal persuasion by the central bank to encourage banks to restrict lending during inflation.
4. Direct Action
    a. Central bank takes strict actions like refusing rediscounting or canceling licenses of non-compliant banks.

2. Fiscal Policy Measures

These are actions taken by the government to reduce overall demand in the economy.

1. Public Revenue (Taxes)
    a. Increasing taxes, especially direct taxes, reduces disposable income and limits consumer spending.
2. Public Expenditure

   a. Reducing government expenditure on public welfare and development projects lowers demand for goods and services.
3. Public Borrowing
   a. The government borrows from the public, reducing the money available for spending in the economy.

3. Other Measures

1. Increasing Supply of Goods and Services
   a. Encouraging production, importing essential goods, and banning exports of scarce items.
2. Price Control
   a. Fixing maximum prices for essential commodities to curb profiteering.
3. Wage Control
   a. Controlling wage hikes to limit inflationary pressures from rising labor costs.

Monetary policy is better for quick fixes; fiscal policy is better for long-term correction. A coordinated approach works best for stable inflation control.

6.GDP:- It is the money value of all final goods and services produced within the domestic territory of a country during a financial year. Money value is the price of the product. To estimate GDP money value of final goods alone are taken into account. Further the value of goods and services produced in the domestic territory alone will be taken into account That is goods produced outside the country by its nationals will not be considered

GNP:- GNP is the money value of all final goods and services produced in a country including net factor income from abroad.

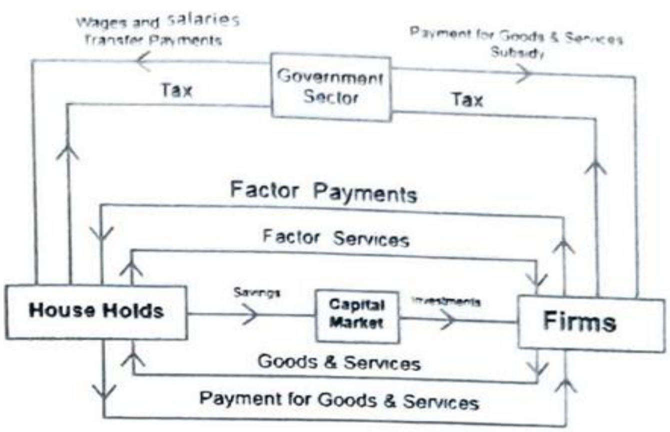
GNP = GDP + NFIA

9,10,11. In a three-sector model, the government sector is included along with the household and firm sectors. In this model:

- Households and firms pay taxes to the government.
  → Taxes are a leakage from the income stream.
- The government spends money on goods and services from firms and pays subsidies to firms.
  → Government expenditure is an injection into the economy.

Budget Types and Circular Flow

- Balanced Budget:
  If government expenditure = taxes, there is no disturbance in the circular flow.
- Surplus Budget:
  If government expenditure < taxes, there is a net leakage, and the size of the circular flow reduces.
- Deficit Budget:
  If government expenditure > taxes, there is a net injection, and the circular flow expands.



In a four sector model, the foreign sector is added to the three existing sectors: households, firms, and government. The inclusion of the foreign sector makes the economy an open economy.

1. Role of the Foreign Sector:

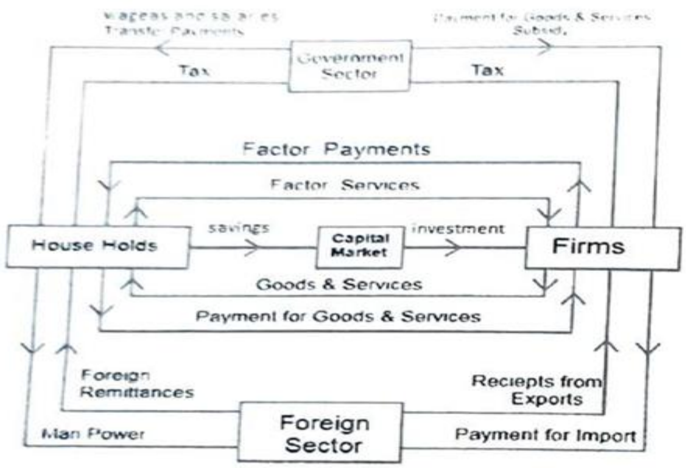
- Households may export their manpower (labour) to foreign countries and receive foreign remittances in return.
- Firms:
  - Export goods and services to the foreign sector and receive foreign currency (an injection).
  - Import raw materials and inputs from abroad and make payments for imports (a leakage).

2. Nature of Exports and Imports:

- Exports: Treated as injections into the economy since they bring income from outside.
- Imports: Treated as leakages, as money flows out of the domestic economy.

3. Circular Flow Implication:

- The circular flow in the four sector model shows interaction among households, firms, government, and the foreign sector.
- It reflects both domestic economic activities and international trade.
- A balanced flow occurs when total injections = leakages.



In a simple two-sector model, the economy consists of only two sectors: households and firms.

1. Role of Households:

- Households possess all the factors of production (land, labor, capital, and entrepreneurship).
- They provide these factor services to firms and receive factor payments such as rent, wages, interest, and profit.
- The entire income earned (denoted as Y) is spent on purchasing goods and services from firms.

2. Role of Firms:

- Firms hire factor services from households to produce goods and services.
- These goods and services are then sold back to the households.

3. Assumptions:

- There is no saving in this model.
- Income (Y) = Factor Payments (FP) = Value of Output (V)

4. Circular Flow Explanation:

- Factor Market (Upper Part): Flow of factor services from households to firms and factor payments in return.
- Commodity Market (Lower Part): Flow of goods and services from firms to households and consumption expenditure in return.

This completes the real flow (goods/services and factor services) and money flow (factor payments and consumption expenditure).

Two Sector Model with Capital Market

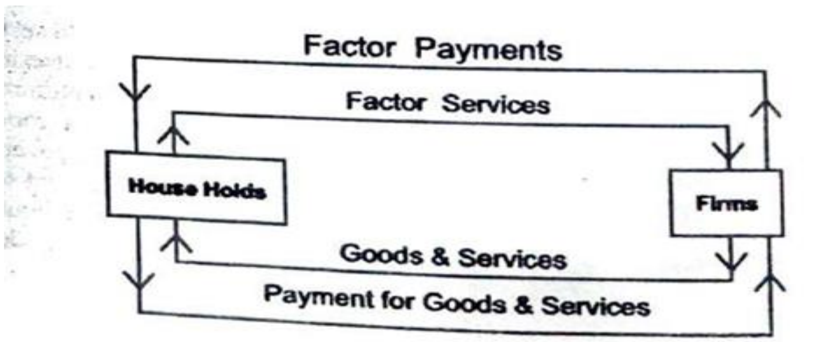
In a modified two-sector model, it is assumed that households do not spend all their income; they save a part of it.

1. Saving and Investment:

- Savings by households are a leakage from the circular flow.
- These savings enter the capital market.
- Firms borrow these savings for investment, which is considered an injection into the economy.

2. Equilibrium Condition:

- For the circular flow to remain undisturbed:
  Saving = Investment



8.

Distinction Between Final Goods and Intermediate Goods

Basis	Final Goods	Intermediate Goods
Purpose of Use	Consumed by end users and not used for further production	Used in the production of other goods
Inclusion in GDP	Included in GDP calculation	Not included in GDP to avoid double counting
Examples	Furniture bought by a household, food for personal use	Wood used in making furniture, raw materials for factories

13. Government securities are debt instruments issued by the central or state governments to raise funds from the public. They are considered safe and risk-free as they are backed by the government. These securities include Treasury Bills (short-term) and Government Bonds (long-term). Investors receive interest at a fixed rate and get back the principal amount at maturity.

14.

Here’s a neatly formatted note on Nifty, Sensex, Demat Account, and Trading Account that you can copy and paste into Word:

NIFTY

NIFTY is a major stock market index introduced by the National Stock Exchange (NSE) of India. It is a combination of the words "National Stock Exchange" and "Fifty", representing the top 50 equity stocks traded on the NSE. These stocks span across 12 key sectors of the Indian economy such as IT, financial services, consumer goods, pharmaceuticals, automobiles, energy, etc.

NIFTY is managed by India Index Services and Products Ltd. (IISL) and is calculated using the free-float market capitalization weighted method. Its base period is November 3, 1995, and the base value is 1000. Variants of NIFTY include NIFTY 50, NIFTY IT, NIFTY Bank, and NIFTY Next 50.

SENSEX

The SENSEX (Sensitive Index) is the benchmark index of the Bombay Stock Exchange (BSE). It represents 30 well-established and financially sound companies listed on the BSE, often referred to as blue-chip companies.

Initially, SENSEX used a weighted market capitalization method but from September 1, 2003, it shifted to the free-float market capitalization method, which is the global standard. The base year is 1978-79, and the base value was set at 100. A dollar-linked version called DOLLEX-30 was introduced on July 25, 2001.

Demat Account

A Demat (Dematerialised) Account is used to hold shares and securities in electronic form. It facilitates easy and safe online trading by storing all investments such as shares, bonds, mutual funds, and ETFs in one place.

Dematerialisation is the process of converting physical share certificates into digital format. A Demat account works like a bank account — shares purchased are credited and sold shares are debited. It eliminates paperwork, reduces risk, and helps in easy tracking of investments.

Trading Account

A Trading Account is used to buy and sell securities in the stock market. It acts as an interface between the investor and the stock exchange. While a Demat account stores securities, a trading account is needed to execute buying and selling transactions.

To trade online, an investor must have both Demat and Trading accounts. These are usually provided by Depository Participants (DPs) such as brokers and financial institutions.

Bank Rate

Bank rate is the rate at which the Central Bank (RBI) lends money to commercial banks or rediscounts their approved bills of exchange.

- Purpose: To control inflation or stimulate growth by affecting the cost of borrowing.
- Inflation Control:
- Increases bank rate → Cost of borrowing goes up → Commercial banks reduce lending → Money supply decreases → Inflation controlled
- Known as Dear Money Policy
- During Recession:
- Decreases bank rate → Borrowing becomes cheaper → More loans given → Demand increases → Economic activity rises
- Known as Cheap Money Policy

Cash Reserve Ratio (CRR)

- Definition: The percentage of total deposits that commercial banks are required to keep with the RBI in cash.
- Purpose: To regulate liquidity and control inflation.
- Inflation Control:
    - RBI increases CRR → Banks have less money to lend → Loan availability drops → Inflation decreases
- Mandatory: This reserve is maintained on a daily average basis with the RBI.

Statutory Liquidity Ratio (SLR)

- Definition: The percentage of total deposits that commercial banks must maintain in the form of liquid assets like cash, gold, or approved securities.
- Purpose: To ensure the solvency of banks and control credit expansion.
- Inflation Control:
    - RBI increases SLR → Banks invest more in government securities → Less money available for public lending → Inflation controlled
- Difference from CRR:

- CRR is maintained with the RBI,
- SLR is maintained by the bank itself.

Stock index

A **Stock Index** is a **barometer of the stock market** that reflects the overall performance of a group of selected stocks. It gives a **broad idea of market trends**, whether it's moving upward or downward. Since thousands of companies are listed in the stock market, tracking every single stock is difficult. Instead, indices help in summarizing market movements.

Some well-known stock indices in India are:

- **BSE Sensex** – Consists of 30 financially sound companies.
- **NSE Nifty 50** – Represents 50 major companies across 12 sectors.
- **Other indices** – BSE 200, CRISIL 500, Dollex, etc.

Stock indices help investors, analysts, and policymakers to understand the overall economic sentiment and make informed decisions.

Shares represent a unit of ownership in a company. When a person buys shares, they become part-owners of the company and have a claim over its profits and assets. Shareholders receive dividends, but these are not fixed – they may increase, decrease, or not be declared at all depending on the company's performance. Shares do not have a maturity period, making them a permanent investment. However, issuing more shares reduces the earnings per share (EPS), which may lower the return for each investor. While investing in shares carries more risk, it also offers the possibility of higher returns.

Bonds, on the other hand, are debt instruments. They are a form of loan taken by companies or governments from investors. When an investor buys a bond, they are lending money to the issuer for a fixed period. In return, the issuer agrees to repay the principal amount on a fixed maturity date and pay interest either regularly or at the end. Bonds are less risky than shares and offer more stable returns. Since bonds are loans and not ownership, bondholders are considered creditors, not owners.

Basis	Money Market	Capital Market
Time Frame	Short-term (≤ 1 year)	Long-term (> 1 year)
Instruments	T-bills, CPs, CDs	Shares, Debentures, Bonds
Risk Level	Low risk	High risk
Nature	Unsystematic, OTC	Well-organized, regulated
Liquidity	High liquidity	Moderate liquidity
Return	Fixed, lower returns	Variable, higher returns
Institutions	RBI, Banks, Acceptance houses	SEBI, Stock Exchanges, NBFCs
Purpose	Working capital, short-term finance	Fixed capital, long-term finance

Here’s a 7-mark answer discussing the **sources of business financing**:

Sources of Business Financing

Business financing refers to the capital required by a business to fund its operations, growth, and other activities. The sources can be broadly categorized into **internal** and **external** sources:

1. Personal Savings

This is an internal source where entrepreneurs use their own money to finance the business. It is often used during the startup phase and involves no repayment or interest.

2. Retained Earnings

Profits that are reinvested in the business rather than distributed to shareholders. This is a cost-effective and sustainable source of finance for expansion and development.

3. Equity Financing

Funds raised by selling shares of the company to investors or the public. It doesn’t involve repayment but dilutes ownership and may reduce control over business decisions.

4. Debt Financing

Involves borrowing money through loans, bonds, or credit lines. Though it needs to be repaid with interest, it allows the owner to retain full control over the business.

5. Trade Credit

Businesses may receive goods or services from suppliers on credit, paying them later. It helps manage short-term liquidity without immediate cash outflow.

6. Venture Capital

Professional investors provide capital in exchange for equity, especially to high-growth startups. They often bring expertise and mentorship along with funding.

7. Government Grants and Subsidies

Governments may provide financial aid to support small businesses or promote economic development in certain sectors or regions. These do not require repayment but may come with specific usage guidelines.

Module 5

1. Differentiate between devaluation and depreciation.(3 marks)

2. Examine the advantages of protectionism in international trade. (3 marks)

3. Explain the Absolute Advantage Theory of international trade. (7 marks)

4. (With the help of a diagram) Examine the effects of tariff. (7 marks)

5. What is meant by Balance of Payments (BOP)? What are the measures to correct disequilibrium in BOP? (7 marks)

6. Explain the Comparative Cost Advantage Theory. (7 marks)

7. What is international trade? List out the advantages of foreign trade. (3 marks)

8. What is Balance of Payments?List out its components. (3 marks)

9. Differentiate between the Theory of Absolute Advantage and the Theory of Comparative Advantage. (10 marks)

10. Examine the tariff and non-tariff barriers to international trade. (4 marks)

11.Differentiate between free trade and protectionism. List any six arguments in support of protectionism. (10 marks)

12. What do you mean by devaluation? Explain the conditions for its success.(4 marks)

12. Examine the Comparative Cost Theory. Point out any two criticisms against this theory. (7 marks)

13. b) What is protection? State any five arguments in favour of protectionism. (7 marks)

14. a) What are the disadvantages of foreign trade? Examine the effects of quotas on international trade. (7 marks)

14. b) Evaluate the success or failure of devaluation when the demand for import is more elastic or less elastic. (7 marks)

15. Point out any three items coming under Unilateral Transfers Account. (3 marks)

16. What is Balance of Payments? (3 marks)

17. What is international trade? List out the advantages of foreign trade. (7 marks)

18. b) What are tariff barriers? Explain their impact on the economy. (7 marks)

19. a) What are the arguments in favour of free trade? (7 marks)

19. b) Explain the Absolute Advantage Theory with the help of an example. (7 marks)

Answers

1.

Basis	Devaluation	Depreciation
Definition	A deliberate reduction in the value of a country's currency by the government.	A fall in the value of a currency due to market forces (demand and supply).
Control	Controlled by the government or central bank.	Happens automatically in a floating exchange rate system.
Cause	Used as a policy tool to correct a deficit in the balance of payments.	Occurs due to unfavorable economic conditions or market speculation.
Exchange Rate	Involves a change in the official exchange rate.	No change in the official rate; value changes based on market trends.
Effect	Encourages exports and discourages imports.	Also makes exports cheaper and imports costlier, but not due to policy decision.

2.

1. Infant Industry Argument

2. Strategic and Key Industry Argument
3. National Defence
4. Unfair Competition
5. Job Preservation
6. Diversification
7. Terms of Trade Improvement
8. Improving Balance of Payments
9. Anti-Dumping
10. Employment Generation
11. Keeping Money at Home
12. Equalization of Production Costs
13. Expanding the Home Market

1. Infant Industry Argument

New or growing industries in a country may not be able to compete with well-established foreign firms. Protectionism helps such industries by giving them time to develop their technology, reduce costs, and gain market strength before facing global competition.

2. National Defence

Some sectors like defense are too important to depend on foreign countries. In times of war or political tension, access to foreign defense supplies may be restricted. So, protecting and developing such industries is crucial for national security.

3. Anti-Dumping

Sometimes foreign companies sell goods at very low prices to destroy local competitors, a practice known as dumping. Protectionist measures like tariffs can prevent this and protect domestic industries from unfair pricing tactics.

3.

Proposed by: *Adam Smith*

Year: *1776*

Main Idea:

A country should specialize in the production and export of goods that it can produce **more efficiently** (at a lower cost or with fewer resources) than other countries, and import goods in which it is **less efficient**.

1. Two countries and two commodities.
2. Free trade exists between countries.
3. Labour is the only factor of production.
4. Labour is homogeneous and perfectly mobile within a country but immobile between countries.

Country	Wheat (units per labour)	Cloth (units per labour)
USA	10	5
UK	5	3

- USA has an **absolute advantage** in **wheat** (10 > 5).
- UK has an **absolute advantage** in **cloth** (3 > 2 or 5).

So, according to this theory:

- USA should specialize in producing and exporting **wheat**.
- UK should specialize in producing and exporting **cloth**.

Each country can **benefit from trade** by focusing on what they do best and exchanging goods.

Benefits:

- Efficient use of world resources.
- Higher total output and mutual gains.
- Encourages specialization and division of labour.

4. The following are the effects of tariff on the economy.

i) Protective effect: When an import duty is imposed, imports become costlier. Hence, the demand for domestic goods will increase and it will protect the domestic industries.

ii) Revenue effect: A tariff will increase the revenue of the government if it does not completely stops the imports.

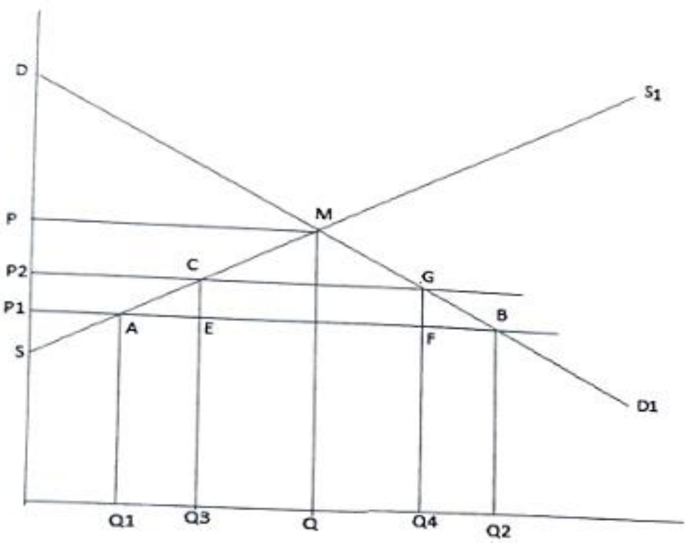
iii) Income and employment: A tariff will increase the demand for domestic goods. Hence it will increase production, employment and income in the home country.

iv) Balance of payments effect: Tariff may help to improve the balance of payments as its restrict the imports.

v) Consumption effect: An import duty will increase the price of the commodities and hence it will reduce the buying capacity of the people.

vi) Competitive effect: An import duty protects the domestic industries and hence it may reduce competition in the economy. This can lead to inefficiencies.

vii) Redistribution effect: If the import duty increases the price of a domestically produced product, it leads to a redistribution of income in favour of the producers.



- DD1 is the domestic demand curve.
- SS1 is the domestic supply curve.
- Under free trade, price is P1, domestic producers supply Q1, and imports fill the gap from Q1 to Q2.
- When a tariff is imposed, price rises from P1 to P2.
- Domestic supply increases from Q1 to Q3, and imports fall to Q3 to Q4.
- Consumption decreases from Q2 to Q4.

5.

Balance of Payments is a **systematic record** of all economic transactions of a country with the rest of the world during a specific period, usually a year. It includes **exports and imports of goods and services, capital movements**, and **unilateral transfers**. BOP helps the government and other institutions understand the **international currency position** and formulate suitable economic policies.

Disequilibrium in BOP occurs when there is a **persistent deficit or surplus**. The following are some important methods to correct a deficit:

1. Automatic Correction:

When there is a deficit, the **exchange rate falls** due to higher demand for foreign exchange. This makes **exports cheaper** and **imports costlier**, thereby automatically correcting the imbalance.

Deliberate measures the following ere the deliberate measures

2. Monetary Measures:

a) **Monetary Contraction**: Reducing money supply decreases purchasing power, lowers imports, and boosts exports.
b) **Devaluation**: Deliberately lowering the currency value makes domestic goods cheaper for foreigners (exports rise) and foreign goods more expensive (imports fall).
c) **Exchange Control**: The government takes control of foreign exchange earnings and allocates them for essential imports only.

3. Trade Measures:

a) **Export Promotion**: Removing export duties, giving subsidies, and supporting export-oriented industries.
b) **Import Control**: Increasing import duties, imposing quotas, and licensing to discourage unnecessary imports.

4. Miscellaneous Measures:

Encouraging **foreign investment**, **promoting tourism**, and securing **foreign aid** can bring in foreign exchange and help correct BOP deficit.

1. Current Account:

This records transactions of **goods and services**.

- **Merchandise Exports and Imports (Visible Trade):** Exports are credits, imports are debits.
- **Invisible Exports and Imports:** Includes services like transport, insurance, tourism, interest, and dividends.

2. Capital Account:

Records **capital transfers** and acquisition/disposal of **non-produced, non-financial assets**.

- Includes **loans and borrowings**, and **investments** (like foreign direct investment or portfolio investment).
- **Capital inflow** is a credit entry, while **capital outflow** is a debit entry.

3. Unilateral Transfers (Transfers Account):

These are **one-way transactions** with no return.

- Includes **remittances**, **foreign aid**, **charity**, **gifts**, and **membership payments** to international agencies.

4. Official Reserve Account:

Managed by the **central bank**; includes **foreign currencies**, **gold reserves**, and **special drawing rights (SDRs)**.

- Used to **stabilize the exchange rate** and manage international liquidity.

6. Sure! Here's a clean and structured answer for the **Comparative Cost Advantage Theory** for your exam (7-mark question):

Comparative Cost Advantage Theory

The theory of **Comparative Cost Advantage** was developed by **David Ricardo in 1817** (not 1857; the year in your notes seems to be a typo) and later refined by economists like **J.S. Mill** and **Marshall**. This theory explains how countries can benefit from international trade even if one country has no absolute advantage in producing any good.

Core Idea:

Even if a country is less efficient in producing both goods, it should **specialise in producing the good where its absolute disadvantage is the least** and import the other.

In contrast, the other country should specialise in the good where its relative efficiency is higher.

Example (England & Portugal):

- Two commodities: **Cloth and Wine**
- **Portugal** requires:
  - 90 units of labour for 1 cloth
  - 80 units of labour for 1 wine
- **England** requires:
  - 100 units of labour for 1 cloth
  - 120 units of labour for 1 wine

Portugal has **absolute advantage** in both goods.

However:

- **Portugal's cost ratio**: 1 wine = 0.88 cloth
- **England's cost ratio**: 1 wine = 1.2 cloth

Hence:

- Portugal has **comparative advantage** in wine
- England has **comparative advantage** in cloth

So Portugal should **specialise in wine**, and England in **cloth**, and they should trade with each other to **mutually gain**.

Assumptions of the Theory:

1. Two countries, two commodities
2. No trade barriers
3. No transport cost
4. Labour is the only factor of production
5. Perfect competition and full employment

6. Labour is homogeneous and mobile within a country
7. Goods are exchanged based on relative labour costs

Criticisms:

1. Labour is not the only element of cost
2. Exchange rates are not solely based on cost – demand and supply matter
3. Full employment and perfect competition are unrealistic
4. Assumes free trade, which is rare
5. In real life, big countries may not fully specialise
6. The theory shows only the **limits** of exchange ratio, not the exact point

8. **International trade** refers to the **exchange of goods and services between countries**. It is also known as **foreign trade**, and it allows countries to obtain products they cannot produce efficiently or economically on their own. The branch of economics that studies such transactions is called **International Economics**.

1. **Optimal use of natural resources**
2. **Availability of all types of goods**
3. **Specialisation**
4. **Advantages of large-scale production**
5. **Stability in prices**
6. **Establishment of new industries**
7. **Increase in efficiency**
8. **Development of transport and communication**
9. **International cooperation and understanding**
10. **Discouragement to monopolies**
11. **Better employment opportunities**

Here's a **10-mark answer** for the question:

Differentiate between the Theory of Absolute Advantage and the Theory of Comparative Advantage

Basis of Difference	Absolute Advantage Theory	Comparative Advantage Theory
Introduced by	Adam Smith	David Ricardo
Year	1776	1817
Main Idea	A country should produce and export goods in which it has an **absolute advantage** (i.e., it can produce more efficiently than others).	A country should specialize in goods in which it has a **comparative advantage** (i.e., it can produce at a lower opportunity cost), even if it lacks absolute advantage.
Focus	Absolute cost difference	Relative cost (opportunity cost) difference
Advantage Condition	One country is more efficient than another in producing one product, and vice versa.	One country is less inefficient in producing a good compared to another (i.e., has a smaller absolute disadvantage).
Production Efficiency	Based on highest productivity with same resources	Based on lowest opportunity cost of production
Trade Possibility	Trade is possible only if both countries have absolute advantages in different goods.	Trade is possible even if one country is more efficient in producing both goods.
Number of Countries & Goods	Two countries, two goods	Two countries, two goods (same assumption, but extended later)
Assumptions	Full employment, perfect competition, no transport cost, labor as the only input, etc.	Similar assumptions, but with added focus on opportunity cost

Example	If USA produces 10 units of wheat per labor and UK 5 units, USA has absolute advantage in wheat.	Even if Portugal is better at producing both wine and cloth, England can still trade if it has lower opportunity cost in one good.
Limitation	Narrow in scope as it doesn't explain trade when one country has absolute advantage in both goods.	More realistic and broader – explains trade even when one country is superior in both goods.

10.

1. Tariff Barriers:
Tariffs are taxes imposed on imported goods. They make foreign goods more expensive, encouraging consumers to buy domestic products. Tariffs have several effects:

- **Protective Effect:** Increases domestic production by protecting local industries.
- **Revenue Effect:** Generates income for the government through import duties.
- **Consumption Effect:** Higher prices reduce overall consumption.
- **Redistribution Effect:** Transfers income from consumers to producers.
- **Competitive Effect:** May reduce competition and cause inefficiencies.

2. Non-Tariff Barriers (NTBs):
NTBs restrict trade without using tariffs. They are increasingly used, especially by developed countries. Common NTBs include:

- **Voluntary Export Restraints (VERs):** Export limits self-imposed by the exporting country.
- **Technical Barriers:** Standards and regulations that imports must meet.
- **Licensing Requirements:** Restrictions through permits and quotas.
- **Administered Protection:** Includes safeguards, minimum pricing, and surveillance to protect local industries.

11. Free Trade
Free trade refers to a policy where governments do not restrict imports or exports through tariffs, quotas, or other trade barriers. It promotes the exchange of goods and services between countries without restrictions, allowing the forces of supply and demand to set prices.

Protectionism

Protectionism is the practice of restricting foreign trade to protect domestic industries from foreign competition. It involves the use of tariffs, subsidies, import quotas, and other barriers to reduce imports and encourage local production.

- **Marshall-Lerner Condition**
  For devaluation to successfully improve a country's balance of payments, the combined price elasticity of demand for the country's exports (ex) and imports (em) should be greater than one. This condition is known as the **Marshall-Lerner condition**:
- **ex + em > 1**
  This means the demand for both exports and imports must be sufficiently responsive to price changes. If this condition is met, the devaluation will likely improve the trade balance as the demand for exports increases and imports decrease.
- **Elasticity of Demand**
  The demand for both exports and imports should be price-elastic. If consumers and foreign buyers are not responsive to price changes (i.e., inelastic demand), devaluation may not lead to increased exports or reduced imports, and the trade balance may not improve.
- **J-Curve Effect**
  In the short term, devaluation might initially worsen the balance of payments before showing improvements. This phenomenon is known as the **J-curve effect**, where the trade balance deteriorates initially due to the time it takes for demand to adjust, and then improves as exports increase and imports decrease.
- **Time Lags and Structural Adjustments**
  The success of devaluation depends on the time it takes for export and import adjustments to occur. A quick reaction from foreign buyers and domestic consumers is essential for devaluation to be effective. Additionally, industries may need time to adjust their production methods to meet the demand for more exports.
- Labour is not the only element of cost.

12. Labour Is the only element of cost

Exchange ratio is not always fixed according to the cost ratios. Demand and supply play

an important role in fixing the price.

The assumption of full employment and perfect competition are not valid.

The assumption of free trade (trade without barriers) is highly unrealistic.

6 Labour is homogeneous

According to Graham if one country is very small and other country is big complete specialisation may not be possible. The big country cannot sell its entire surplus to the small

.Goods are exchanged according to the relative amount of labour embodied in them.

country

The theory of comparative cost gives the limit within which exchange ratio will be fixed.It does not say how the exact point within these limits is determined.

15. Gifts and Donations
Foreign Aid
Pensions and Remittances

protection refers to a policy or measures taken by a country to shield its domestic industries from foreign competition. This is typically achieved through **tariffs** and **non-tariff barriers** like quotas, subsidies, and import restrictions.