QUESTION BANK - 1

Questions That Will carry 2 Marks:

Question 1:

A)

What economic issues does Macroeconomics address?

Answer:

Macroeconomics focuses upon economic growth, business cycles, unemployment, inflation and the output effects of globalization.

B)

What is nominal GDP and real GDP?

Gross domestic product is the most frequently quoted macroeconomic measure. Gross domestic product (GDP) measures the domestic economy's output of final goods and services. GDP is measured in current prices, classified as nominal GDP, or in prices of a given year, classified as real GDP. When presented in current prices, GDP measures total output using prices that existed each year. By measuring output with prices that existed during a reference year, the economist is able to isolate changes in output from changes in the price level.

C)

What do you understand by economic growth?

Answer:

Economic growth refers to the increase in real GDP over time. An economy's ability to produce increases over time when there is capital accumulation and technological change, which enhance labour productivity, and growth of population, which, with a lag, increases the economy's labour supply. Economic growth not only increases the standard of living for many individuals in the labour force; but also allows society to care better for those who are unable to work.

D)

What do you understand by a country's "Balance of Payments"?

Answer:

A country's balance of payments is a summary statement of its transactions with the rest of the world. A country has credit (+) entries in its balance of payments when it receives foreign currency and debit (—) entries when it remits foreign currency. Subsets of the balance of payments statement measure the balance of trade, current account balance, and capital account balance.

D)

(a) What is a leakage from the circular flow? (b) Why is investment spending viewed as an injection into the circular flow?

Answer:

(a) A leakage occurs when income received is not spent by its recipient; for example, when households are the sole recipient of income from production, their decision to save is a leakage from the flow of income and spending.
(b) Investment represents an injection of spending into the circular flow. Those who desire to invest obtain funds from those who save.

E)

What are direct and indirect taxes?

Answer:

Direct taxes are taxes levied upon earned income. Examples of direct taxes include federal, state and/or local taxes imposed upon household and/or business income. Indirect taxes are taxes levied on goods and services at production or at final sale and are thereby passed on to the final buyer through higher prices. Examples of indirect taxes include excise taxes, sales taxes, business property taxes, import duties, and license fees.

F)

What four different types of market organization do economists usually identify?

Answer:

The four different types of market organization that economists usually identify are perfect competition, monopolistic competition, oligopoly, and pure monopoly. The latter three forms of market organization fall into the realm of imperfect competition.

G)

To what length of time does the market period refer?

Answer:

The market period refers to the period of time over which the market supply of a commodity is completely fixed. This may be one day, one month, one year, or more and depends on the industry involved. For example, if fresh strawberries are delivered to the APMC market every Monday and no other deliveries can be made during the same week, then the market period for strawberries in APMC is one week. For wheat, the market period extends from one harvest to the next or for one year. For Da Vinci’s paintings, the market period refers to an infinite length of time.

H)

How many units of the commodity can the firm sell in the short run at the equilibrium price?

Answer:

Since the perfectly competitive firm faces an infinitely elastic demand curve, it can sell any amount of the commodity at the given market price.

Questions That Will carry 5 Marks:

Question 2:

A)

What is the importance of an economic model? What are exogenous and endogenous variables with reference to economic models?

Answer:

To help understand the complexity of macroeconomic events, economists use economic models which reduce the complexity of the real world. Models allow economists to link a phenomenon which they wish to explain (the dependent variable) to one or two variables (the independent variables) believed to be largely responsible for the behaviour of the phenomenon under study.

Variables in a model are endogenous or exogenous. A variable is endogenous when its value is determined by the model. A variable is exogenous when its value is determined by forces outside the model. A dependent variable is endogenous.

B)

What do you understand by Inflation? Explain with reference to CPI, PPI, and GDP deflator.

Answer:

Inflation exists when there is a sustained increase in the price level. The consumer price index (CPI), the producer price index (PPI), and the GDP deflator are frequently used measures of the price level. The consumer price index measures price changes for goods and services purchased by urban consumers. The producer price index measures price changes for goods at the wholesale level, specifically finished goods, intermediate goods, and crude materials. The GDP deflator measures changes in price for goods and services included in GDP. A n inflation rate can be calculated from each of these indices by relating the change in the price index between two years to the price index in the first of the two years being compared.

C)

Explain the terms *(a) business cycle*, (*b*) *stabilization policy,* and (c) *monetary and fiscal policy*

Answer:

(a) Business cycles are recurrent, but not periodic, fluctuations in economic activity that occur around the secular trend of GDP over a period of several years. The expansionary phase of the business cycle normally peaks at a point above trend growth, whereas the trough for the contractionary phase is normally below trend growth.
(b) A stabilization policy is an action taken by government to impact aggregate demand to moderate the expansion and contraction phases of the business cycle. During an expansion, the objective is to moderate the growth of spending; the objective during a recession (economic contraction) is to reduce the rate of decrease in spending.
(c) Monetary policy aims to stabilize economic activity by controlling the money supply or interest rates while fiscal policy utilizes a change in tax rates and/or the level of government spending for the same objective.

<u>Questions That Will carry 5 Marks:</u>

Question 3:

A)

(a) What is the difference between equilibrium and disequilibrium? (b) When disequilibrium exists, is the amount produced determined by aggregate supply or aggregate demand?

Answer:

(a) Equilibrium exists when the price level clears the market with aggregate supply equal to aggregate demand. There is disequilibrium when the price level exists at a level where the quantity that can be produced does not equal the quantity that is being demanded. In economics we normally focus upon the clearing of markets, and therefore equilibrium. The Keynesian model is built upon the belief that prices and wages do not adjust rapidly to changes in supply and/or demand, and that disequilibrium can persist for a period of time.

(b) When prices are above the market-clearing level and quantity demanded is less than quantity supplied, businesses elect to produce an amount equal to the quantity demanded. Therefore, they produce an amount determined by a specific price level and aggregate demand. When prices are below the market clearing level, the business sector produces an amount determined by the specific price level and aggregate supply.

B)

(a) What are the components of gross investment? (b) Why are additions to inventory a component of net investment? (c) Can inventory additions be negative?

(a) Gross investment consists of commercial and residential construction, the purchase of machinery, equipment and tools, and the change in business inventory.

(*b*) Businesses hold materials as well as semifinished and finished goods, i.e., inventory, to facilitate the production and sale of goods. Inventory is held for the same reason that a firm purchases machinery, equipment, and tools, namely to acquire assets which are necessary for the production and sale of goods. Additions to a firm's inventory represent net investment, since these goods, like plant and investment, contribute to future sales.
(c) Yes. When expected sales do not materialize, firms hold less materials and finished and semifinished goods inventory. The reduction of inventories, *ceteris paribus,* results in a negative change in inventory investment.

C)

What is the difference between personal income and national income?

Answer:

Personal income is the income received by households during a given year. National income is the sum of payments made to economic resources. In a free enterprise economy, economic resources are owned by households, but government and the corporate form of business organization divert some of the income flow from households when corporations earn profits and government mandates that households make contributions to social security. Some of these diverted funds, however, are returned to households as government and business transfers arid interest on the public debt. Thus, personal income can be less than, equal to, or greater than national income, depending upon the net diversion of funds from households by government and corporations.

Questions That Will carry 5 Marks:

Question 4

A)

(a) GDP is the market value of final output. What is the difference between a final good and an
intermediate good? (b) Why would inclusion of intermediate goods in measuring GDP involve double counting?

Answer:

(a) A final good does not require further processing and is purchased for final use (e.g., clothing purchased by a consumer or a machine by a manufacturer). An intermediate good (1) requires further processing during the year before it is ready for final use, (2) is being purchased for modification before final use, or (3) will be resold during the year for a profit.
(b) Intermediate goods are components of final goods. If the value of both intermediate and final goods is included in the measurement of final output, there would be a double counting of value and therefore an overstatement of GDP.

B)

(a) What is the CPI? (b) Does an increase in the CPI always indicate an increase in the consumer's cost of living?

Answer:

(a) The CPI is a measure of the prices paid by the typical urban working-class family for a fixed basket of goods and services. Statisticians have sampled "typical" consumers to establish a relevant basket of goods which is purchased and the appropriate relative importance (weight) of each good. The basket consists of goods and services divided into the following categories: food and beverages, housing, apparel, transportation, medical care, entertainment, and other.
(b) Although the CPI is the most reliable measure of the cost of living, it may overstate the prices individuals pay for goods and services that

they actually purchase over time. Because it is a fixed- weight index, it does not allow for substitution effects, where consumers may “shop” for goods whose prices are rising and/or select a substitute good whose price has experienced a smaller relative increase. The quality of goods also changes, so that a price increase may reflect improved quality rather than inflation. For these reasons, the CPI may not truly reflect consumers’ cost of living.

C)

What are the causes of unemployment?

Answer:

Unemployed workers can be placed into three categories: frictional, structural, and cyclical unemployment. Frictional unemployment is short-term, usually up to six months; it consists of temporary layoffs (perhaps due to a temporary decrease in the demand for labour), labour which has voluntarily left a job, and re-entrants and new entrants into the labour force, who have a longer job search. Structural unemployment is longer term; it exists because of skill and/or location mismatching in the labour markets. For example, a job applicant may not have the required skill for a particular job; or a job may exist in another region but labour is unaware of its availability or is unwilling to relocate. Cyclical unemployment exists because of the business cycle. A deficiency of labour demand relative to supply periodically develops when decreases occur in economic activity.