MBA(FT) – March/April 2017

MBAFT-6203 Economic Environment of Business

Time : 3 Hours *Max. Marks : 50*

Answer any FIVE questions. All questions carry equal 10 marks

1. The goods market of an economy is characterized by:
   $C = c_0 + c_1 Y_D$
   $T = T_0$
   $G = G_0$
   $I = b_0 + b_1 Y$
   where Y stands for domestic income/output, Y_D stands for disposable income, C stands for consumption demand, I stands for investment demand, T stands for taxes, G stands for Government expenditure. c_0, b_0, $b_1 > 0$, $0 < c_1 < 1$, T_0, G_0 are constants. Consider the Keynesian Model of Goods Market to answer the following questions:
   i. Discuss the rationale behind this particular form of investment demand. Draw the investment demand as a function of output.
   ii. Solve for equilibrium output in the goods market. Draw appropriate graph.
   iii. What is the value of the multiplier? How does the relation between investment demand and output affect the value of the multiplier? Determine the condition under which the multiplier will be positive? Note, that the condition must signify relationship between the exogenous parameters. Interpret the condition in terms of the behavior of the actors in the goods market.
   iv. The parameter b_0 is sometimes called *business confidence*. For a given change in b_0 will there be change in investment demand? Explain. If yes, then will the magnitude of change be more or less than 1? What will happen to national savings? Explain.

   2+2+3+3

2. i. How does demand for money depend on income and interest? Why is it important to understand the relationship between price of bond and rate of interest, before examining the relationship between speculative demand for money and interest?
   ii. When sensitivity of demand for money to changes in interest rate tends to infinity, why does expansionary monetary policy fail in impacting interest rate? Discuss in the context of Keynesian economics.
   iii. Examine the impact of demonetization on India's demand and supply of money. You may substantiate your argument in view of Keynesian analysis.

   3+3+4

3. The following is part of the 2017 Indian budget analysis reported in one of the leading newspapers, highlighting the expenditures:

"The largest of these (expenditures) amounting to Rs. 1.45 trillion, is food subsidy, a merit subsidy mandated under the National Food Security Act. Considerable savings could be realized by better managing the food subsidy and eliminating all the other non-merit subsidies. The Petroleum and Diesel subsidies have indeed been eliminated. But kerosene and LPG are still being subsidized and the fertilizer subsidy has also been maintained at Rs70,000 crore. ....

Defence expenditure is the next largest item, accounting for 12% of total expenditure and nearly a third of capital expenditure. .....

Infrastructure, a major priority of this government, absorbs 9% of total expenditure excluding railway revenue expenditure, and 40% of capital expenditure. That goes up to 56% if we also count railway capital expenditure from extra-budgetary resources. But most of this expenditure is allocated to transport, especially roads and railways. New investment in other infrastructure has been left largely to the private sector. This is justifiable for energy and communications, but not for irrigation, where large externalities are involved, requiring public action.....

In sharp contrast to defence and infrastructure, the allocations for all the social services taken together are only 5% of total expenditure, i.e., less than half the total spending on defence. The core social services, education, health and sanitation and water supply get shares of 1%, 1%, and 0.6%, respectively. These are state subjects but also merit services of vital national importance, essential for the rapid growth of productive employment. Per capita public expenditure on education and health is the lowest in India among all emerging market economies and all major Asian economies. "

i. In class we have discussed the disconnect between measured GDP as a measure of overall well-being and deprivations observed on ground (particularly in developing countries). In several cases, higher GDP per capita may not signify enhanced welfare. The Indian Government is keenly aware of this issue. On the basis of the above information (and ignoring the value judgement made by the author of the article), comment on how the Government is thinking about addressing the current state of multi-faced deprivation in India. To answer, first go through the list of issues that are addressed in this article and then assess how the Government is planning to tackle those. Comment on Government's priorities and express your own opinion while commenting.

ii. How can GDP measure better capture the welfare issues? Suggest ways to modify GDP and explain your rationale. If you are creating an index, make sure you explain the relative weights.

5+5

4. The following two questions are with respect to Open Economy:
   i. In the context of Balance of Payment, explain the meaning and implication of perfect capital mobility.
   ii. 'A nation loses control over money supply under fixed exchange rate regime with perfect capital mobility (and constant prices), thus making monetary policy completely ineffective in changing output. However, fiscal policy is fully effective in such case." Do you agree? Illustrate and explain.

2+8

5. Suppose the Central Bank of an economy is targeting inflation in the short-run. It is also working very closely with the Government and intends to complement Government's broad objectives regarding output. Following a negative exogenous shock, we now observe the following:
   a. Inflation is low.
   b. Lower GDP forecasting
   c. Price of T-Bill is falling.

   i. The Government wishes to increase GDP by increasing Government spending. The Central Bank wishes to support the Government and does not foresee any major added inflation in the short-run. What should the Central Bank do and what tools can be used to that? Explain qualitatively using an appropriate framework. Draw the appropriate graphs and show the changes. You can use multiple frameworks to answer this question. State your reasons and assumptions clearly.

   ii. Is interest targeting better than inflation targeting? Explain.

   iii. What is velocity of money? How is velocity related to demand for money? Give some examples of Government initiative that can decrease the velocity of money.

   Or.

   iii. Critically analyze the proposal of Universal Basic Income (UBI) in the Economic Survey 2016-2017.

4+2+4

6. Write comments on any *two*:
   i. Impact of a lower income tax in the AD/AS framework
   ii. Phillips Curve in the short and long-run
   iii. Explain the relationship between expansionary fiscal policy and change in budget surplus

5+5