

## Determination of Income and Employment

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### Very Short Answer Type Questions (1 Mark)

1. **Give the meaning of ex-ante savings.**

**Ans. :** Ex-ante savings are the planned savings or expected savings

2. **Give the meaning of deflationary Gap.**

**Ans.** It is the gap between excess of aggregate supply over aggregate demand at full employment level.

3. **What is Ex-ante aggregate demand?**

**Ans.** It is planned or desired aggregate demand.

4. **Give the meaning of Inflationary Gap.**

**Ans.** It refers to the amount by which the actual aggregate demand exceeds the level of aggregate demand required to establish the full employment equilibrium.

5. **What is meant by ex-ante investment?**

**Ans. :** It is planned or desired investment during a particular period.

6. **Define aggregate demand.**

**Ans.** Aggregate demand is defined as the money value of total goods and services demanded by an economy during a given period.

7. **What is propensity to consume?**

**Ans.** Which shows the level of consumption at different levels of income in an economy.

8. **Define marginal propensity to consume.**

**Ans.** It is defined as measure of the rate at which aggregate consumption expenditure changes as national income changes.  $MPC = \Delta C / \Delta Y$

9. **What is involuntary unemployment?**

**Ans .** When people who are willing to work at the giving wage rate do not get work.

10. **What is meant by excess demand in macro economics?**

**Ans.** In macro economics, when aggregate demand is more than aggregate supply at full employment level, then there is excess demand.

11. **What can be the minimum value of investment multiplier?**

**Ans.** Investment multiplier  $K = 1/1 - mpc$  if  $mpc = 0$  then  $K = 1/1 - 0 = 1$  which is minimum

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value of investment multiplier

12. **Give the meaning of aggregate supply?**

**Ans.** Aggregate supply is the money value of total supply of goods and services available for purchase by an economy during a given period.

13. **Can the value of APS be negative?**

**Ans.** Yes, when there are dis savings.

14. **Write the relationship between MPS and multiplier?**

**Ans.**  $K = 1/1 - MPC = 1/MPS$  or inverse relationship between MPS and the size of the multiplier

### Short Answer Type Questions(3-4 Marks)

1. In an economy the MPC is 0.75. Investment expenditure in the economy increase by Rs.75 crore. Calculate total increase in national income.

Ans.  $K = DY/DI = 1/1-MPC$

$DY = DI \times 1/1-MPC$

$= 75 \times 1/1-0.75$

$= 300 \text{ Crore}$

2. An economy is in equilibrium. Its consumption function is  $C=300 +0.8Y$ . and investment is 700 find national income.

Ans. :  $C = 300 + 0.8 Y$

$Y = C + I$

$Y = 300 + 0.8Y + 700$

$= 1250$

3. Giving reasons, state whether the following statements are true or false.

1. When MPC is zero, the value of investment multiplier will also be zero.
2. Value of APS can never be less than zero
3. When  $MPC > MPS$ , the value of investment multiplier will be greater than 5.
4. The value of MPS can never be negative
5. When investment multiplier is 1, the value of MPC is zero.
6. The value of APS can never be greater than 1.

Ans.

1. False because when  $MPC = 0$

Value of investment multiplier is one  $K = 1/1-MPC = 1/1-0 = 1$

2. False because APS is negative when there are dissavings

3. True, if MPC is greater than 0.8 or false if  $MPC > 0.5$  but not greater than 0.8

4. True, since  $MPS = DS/DY$  if  $DS = 0$  then MPS can at the most be zero.

5. True because  $K = 1/1-MPC = 1/1-0=1$

6. True, because  $APC + APS = 1$

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4. **Explain the distinction between voluntary and involuntary employment.**

**Ans.** Voluntary unemployment is that part of the working force not willing to engage itself in gainful occupation. Involuntary unemployment is that part of labour force which is willing and able to work at the prevailing wage rate but is out of work.

5. **Explain the relationship between investment multiplier and MPC?**

**Ans.**  $K = 1/1 - MPC$ , It shows direct relationship between MPC and the value of Multiplier.

Higher the proportion of increased income spend on consumption, higher will be value of investment multiplier. Higher the proportion of increased income spend on consumption, higher will be value of investment multiplier.

## **Long Answer Type Questions (6 Marks)**

**1. Explain the role of the following in correcting deficient demand in an Economy.**

- 1. Open market operation**
- 2. Bank rate**

**Ans:**

1. Open market operation refer to the sale and purchase of securities by the Central Bank incase of deficient demand when AD falling short of AS at full employment, the Central Bank buys securities in the open market and makes payment to the sellers. The money flows out of the central bank and reaches the commercial bank as deposits. This raises the lending capacity of the banks, people can borrow more. This will raise AD.
2. Incase of deficient demand central bank decrease the bank rate which the central bank charges on the loan given to commercial bank. This forces the commercial banks to reduce lending rate. Since borrowing become cheaper and people borrow more. Arises.

**2. Explain the role of the following in correcting 'Excess demand in an Economy'**

- 1. Bank Rate**
- 2. Open market**

**Ans.**

1. To Correct excess demand central bank can rise the bank rate. This forces commercial bank to increase lending rates. This reduces demand for borrowing by the public for investment and consumption. Aggregate demand falls.
2. When there is excess demand Central Bank sells securities. This leads to flow of money out of the commercial banks to the central bank when people make payment by cheques. This reduces deposits with the banks leading to decline in their lending capacity. Borrowing decline. AD declines.

**3. Explain the role of following in correcting the deflationary gap in an economy.**

- 1) Govt. Expenditure**

## 2) Legal Reserve Ratio

**Ans.**

1. In a situation of deflationary gap or deficient demand. The Govt. should raise its expenditure i.e. there will be more economic activities in the economy like, building of roads, bridges, canal etc. This will raise the level of employment. It will in turn increase the income and the purchasing power. Thus aggregate demand will rise.
2. During deficient demand, central bank reduces the CRR. The result of reducing CRR will be seen in the surplus cash reserves with the banks which can be offered for credit. The bank's credit bank reduces SLR, this will have expansionary effect on the credit position of the banks leading to increase in their leading capacity borrowing increases & AD increases.

### 4. Explain the role of margin requirements for correcting the deflationary gap.

**Ans.** Deflationary gap refers to a situation when at full employment level of income AD falls short of AS. It is called deficient demand.

Margin requirements refers to the margin on the security provided by the borrower. When margin is lower, the borrowing capacity of the barrow is higher. When central bank lowers the margin the borrowing capacity of the borrowers increase. This raise AD.

### 5. In an economy 75% of the increase in income is spent on consumption. Investment increased by Rs.1000 Crore. Calculate

**1 Total increase in income**

**2 Total increase in consumption expd.**

**Ans. :**  $MPC = 75\% = 75/100 = 3/4$

$MPS = 1 - 3/4 = 1/4$   $K=4$

1.  $DY = DI \times K$

$= 1000 \times 4 = 4000$  Crore

2.  $DY = DC + DI$

$DC = DY - DI$

$= 4000 - 1000 = \text{Rs. } 3000$  Crore

### 6. In an economy the equilibrium level of income is Rs.1200 Crore. $MPC:MPS = 3:1$ $DI = ?$

**Ans.** New equilibrium income = Rs. 20000 Crore

$= 20000 - 12000 = 8000$  Crore

$K = 1/MPS = 1/0.25 = 4$

$DI = DY/K = 8000/4 = \text{Rs. } 2000$  Crore

## Higher Order Thinking Skills

**1. Why can the value of MPC be not greater than 1?**

**Ans.** It is because change in consumption can never be greater than change in income.

**2. Does an excess of AD over AS always imply a situation of inflationary gap?**

**Ans.** No. Inflationary gap occurs only when  $AD > AS$  corresponding to full employment level of employment.

**3. What happens if  $AD > AS$  prior to full employment level of employment?**

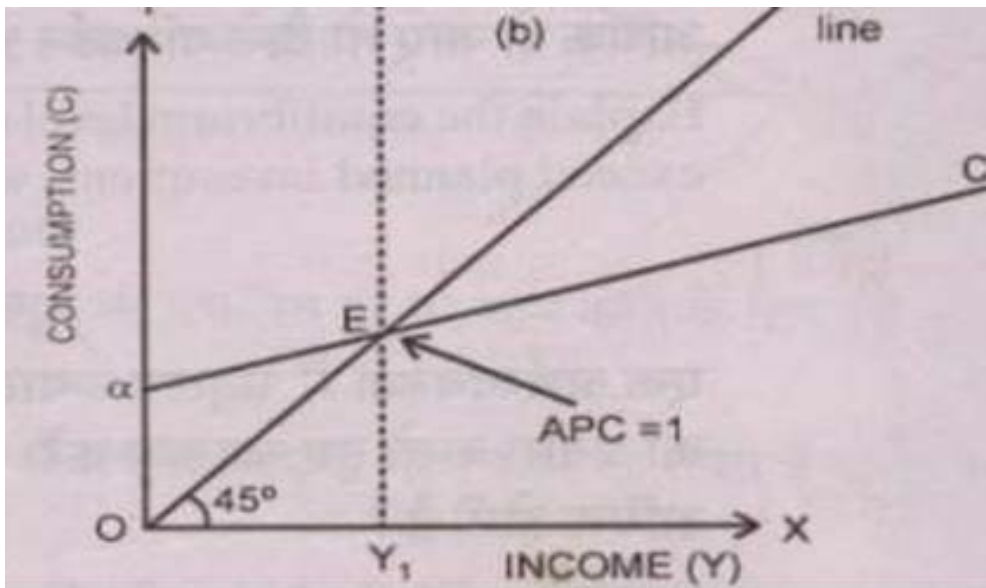
**Ans.** It is a state of disequilibrium in economics. When  $AD > AS$ , producers have to cater to demand out of their existing stock of goods, implying that the desired level of stocks will decrease. It implies greater production & therefore there is increase in AS. This process continues till equilibrium is struck between AD and AS.

**4. In poor countries like India, people spend a high percentage of their income so that APC and MPC are high. Yet, value of multiplier is low. Why?**

**Ans.** Working of the multiplier process is based on one fundamental assumption: that there exists, excess capacity in the economy, so that whenever consumption expenditure rises (implying increase in demand) there is a corresponding increase in production (implying increase in income). But poor countries like India, lack in production capacity. Accordingly, whenever demand increases (in terms of increase in consumption expenditure), there is increasing pressure of demand on the existing output (implying inflation or rise in prices) rather than the increase in output or income.

**5. Show a point on the consumption curve at which  $APC = 1$ .**

**Ans.**  $APC = C/Y = 1$  is possible if  $C=Y$ , i.e. Consumption is equal to Income.



6. **In what respect foreign trade will be useful in removing the adverse economic effects of deficient demand?**

**Ans.** Export increases the demand for goods and services produced in the domestic territory and is helpful to reduce deficient demand.

7. **What happens in an economy, when credit availability is restricted and credit is made costlier?**

**Ans.** Aggregate demands falls.