

# Basic Concepts of Economics

## DEFINATIONS OF ECONOMICS

### 1. Wealth Definition

By Adam Smith

followers of adam smith → J.S. mill, J.B. Say, Malthus

#### Criticism

1. Too much importance given to wealth.
2. Narrow meaning of wealth.
3. Concept of economic man.
4. No mention of man's welfare.
5. It does not study the means.
6. Defective logic.

### 2. Welfare Definition

By Alfred Marshall

followers of Alfred Marshall - Pigou, Cannon, Baveridge.

"Study of man"

#### features

1. Wealth is not be all end and of all human activity. It is only a mean to fulfillment of an end which
2. It is the study of an ordinary man.
3. It is study of material welfare activity of man.

#### Criticism

1. Narrow down scope of economics
2. Vague relation b/w economics & welfare.

3. welfare is vague concept. (Vague-unclear)
4. Impractical
5. Involves value judgement

### 3. Scarcity Definition By Lionel Robbins

According to him economics is science which study human behaviour as a relationship between ends and scarce means which have alternative uses.

#### Features / Merit

1. Give Economics as a status of positive science.
2. Analytical definition
3. Universal definition
4. Clear on the nature and scope of economics
5. Valuation is central problem.

#### Criticism

1. Reduces economics mainly theory of value.
2. Scope of economics has not properly wider.
3. Doesnot cover the study of economic growth
4. Growth oriented Definition

#### By Paul A Samuelson

followers of Paul A Samuelson  
Accepted by All.

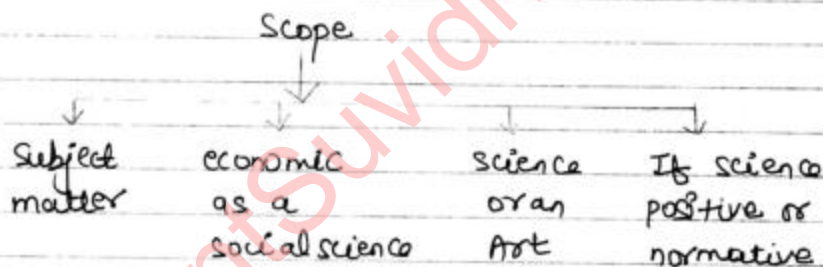
ultimate Definition - Economics is a social science which is concern with proper use of

allocation of resource for the achievement & maintenance of growth stability & efficiency.

features

1. Not merely confined to the present but the future.
2. Dynamic approach by taking economic growth as a integral part of problem.
3. caters to universal problem.
4. Comprehensive Definition.  
(Detail)

Scope (Sphere of study)



1. Subject matter

→ Economic activity

→ want — Efforts — Satisfaction

2. Economic as a social science

Consumption — Satisfaction of wants

Production — Producing things, making an efforts to satisfy the wants.

Exchange — Mechanism money, credit etc.

Distribution — Earning wages, rent, interest & profit.



### 3. Economics as a science or Art

A science is ~~synt~~ systematic body of knowledge ~~become~~ a branch of knowledge become systematic when relevant facts have been collected and analysed in a systematic manner when we discovered explaining fact it becomes science. In economics many laws and principle are discovered like law of demand. Hence it is science.

An art lay down formulate or rules to guide people who want to achieve a certain aim in economics it can be aim of removal of poverty more production etc. thus it is practical.

### 4. Economics whether positive or normative -

A positive science explain why, what is, where, when, How, to obtain i.e. causes and effect. example what are causes of unemployment? How to be accounts for inflation.

normative science explains what ought to be rightness or wrongness of thing.

Ex- what should be the price of food grain.

Economics is both positive and normative science.

It is not only tell us why certain things happened  
It also says whether its right or wrong for  
the thing to happened.

### Example of positive or normative Science

#### Positive Science

#### Normative Science

- |   |  |
|---|--|
| 1. A rise in interest rate will cause a rise in exchange rate and an increase in demand for imported product. | 1. Decision to grant independence for the bank of England is and should be <del>reversed</del>                             |
| 2. Lower taxes may stimulate an increase in active labour supply.   | 2. A national minimum wages is totally undesirable as it does not help the poor and causes higher unemployment & inflation |
| 3. A national minimum wage a slightly to cause a contraction in the demand for low skilled labour.            | 3. National minimum wage should be increase to 5 dollars as a method of reducing poverty.                                  |
| 4. The UK economy now has a lower unemployment rate than Germany.   | 4. Protectionism is the only proper way to improve the living standard of workers whose jobs threatened by cheap imports.  |
| 5. Asian stock market has boom in the recent years.   |  |

## Difference b/w Micro & Macro economics

- | Micro   | Macro   |
|---|---|
| 1. It study individual economic behaviour (house hold, firm, industry).   | 1. It study the aggregate economic behaviour of the people in general.  |
| 2. It deals with the pricing of particularly commodity in an industry.  | 2. It deals with the general price level in the economy (National income accounting, output, employment etc). |
| 3. Study of micro economics is important for resource utilisation, public finance and taking business decision. | 3. Study of macro economics is important for formulation of economic policy of the whole nation.              |
| 4. It consist of independent concept.   | 4. Here the concepts are inter-dependant on one another.  |
| 5. Concepts were popularise by alfred marshall.   | 5. Concepts were popularise by J.M. Keynes.   |
| 6. Concepts have a more theoretical value.  | 6. Concepts have a more practical value.  |

## Interdependence of Micro & Macro economics

1. An individual may become rich by stealing money but the society as a whole cannot get rich by looting each other properties.
2. An individual employer may increase his income by cutting the wages of the workers but it cannot be valid to the employer's class as a whole.
3. A rise in price of an individual commodity make a profit to an individual but the general rise in price level will lead to inflation and



disturb the economy.

Those micro and macro economics is interdependent and very essential for building up the true picture of the economy as a whole. If we ignore one aspect it will lead to a wrong conclusion.

1. A market based economy is clearly the best possible economy system. - Normative
2. The U.S. would be better off spending 10 billion more on national defence rather than high education - Normative
3. The Govt. has adopted policies to reduce unemployment - Positive
4. Unemployment is worse than inflation - Normative
5. Last year the economy grew by 2.2%. - Positive
6. An increase in investment spending will cause the level of economic activity to rise by more than the increase in such spending - Positive
7. The govt. should do more to eliminate the poverty - Normative
8. Nurses should be paid more - Normative
9. Nurses are paid less on average than the doctor. - Positive
10. Inflation is at its lowest for 25 years - Positive

positive = what cause and effect

normative = future analysis

## Few Fundamental Concepts

1. **Wealth** - The stock of goods under the ownership of a person or nation is called wealth.
2. **Personal wealth** - It is defined as the stock of all transferable goods owned by a person. For example - A house is a transferable good because it can be sold off and given away as a gift.
3. **National Wealth** - It is some value of monetary assets minus liability of a given nation. It refers to total value of wealth possessed by the citizens of a nation at a set point in time.
4. **Wealth and welfare** - By welfare <sup>we</sup> mean the satisfaction or <sup>the well-being</sup> ~~the well-being~~ of an individual or society. As wealth increases welfare increases and vice-versa. Thus there is a positive relationship b/w the two.
5. **Money** - Any good i.e. widely used and accepted in transaction involving the transfer of goods & service from one person to another. Money functions as a medium of exchange, a unit of account, standard of deferred payment and a store of value.
6. **Constituence of money supply** - Rupee, notes & coins with the public, credit cards, traveller cheques etc.



7. Market - An actual or nominal place where forces of demand and supply operate and where buyers & sellers interact [~~th~~ Directly or through intermediaries] to trade goods, services, contract etc call money or Barter.

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8. Function of a market

- i) To determine the price of the commodity.
- ii) To determine the quantity of the commodity that will be bought and sold.

9. Market mechanism - It determines the price and the quantity bought & sold of all the goods & services.

10. Investment - It means an increase in the capital stock. It is an asset or an item i.e. purchase with the hope that it will generate income or appreciate in future. It is basically used in the future to create wealth. [Note: It is saving which are actually invested]

11. Real Investment - It means money invested tangible and productive assets such plant & machinery etc.

12. Portfolio Investment - A collection of investment owned by the same individual or orgn. These investment include stock [which are investment in individual business], bonds [which are investments in debts that are designed to earn interest] and mutual funds [which are essential pools of money from many investors that are by professionals or according to indices]

13. Gross Investment - It is aggregate investment made during any year. It include :-
  - a) Inventory investment i.e raw material, semi-finished or finished goods.
  - b) Fixed investment i.e machinery, factory, shed etc.
14. Net Investment - Gross Investment - Depreciation
15. Production - The processes and methods employed to transform tangible inputs (raw material, semi-finished goods etc) and intangible inputs (ideas, information, knowledge) into goods, services or utility [NOTE: It is done for sale in market].
16. Factor of Production - Resources requires for the generation of good & services generally classified 4 major group:-
  1. Land including all natural resources.
  2. Labour including all human resources.
  3. Capital including all man made resources.
  4. Entrepreneur including all of the above resources.
17. Consumption - It is the amount of goods & services use in a particular time period for the satisfaction of human wants.
18. Determinant of Consumption
  1. Current Disposable Income.
  2. Relative Income.
  3. Lifecycle Income.
  4. Wealth.

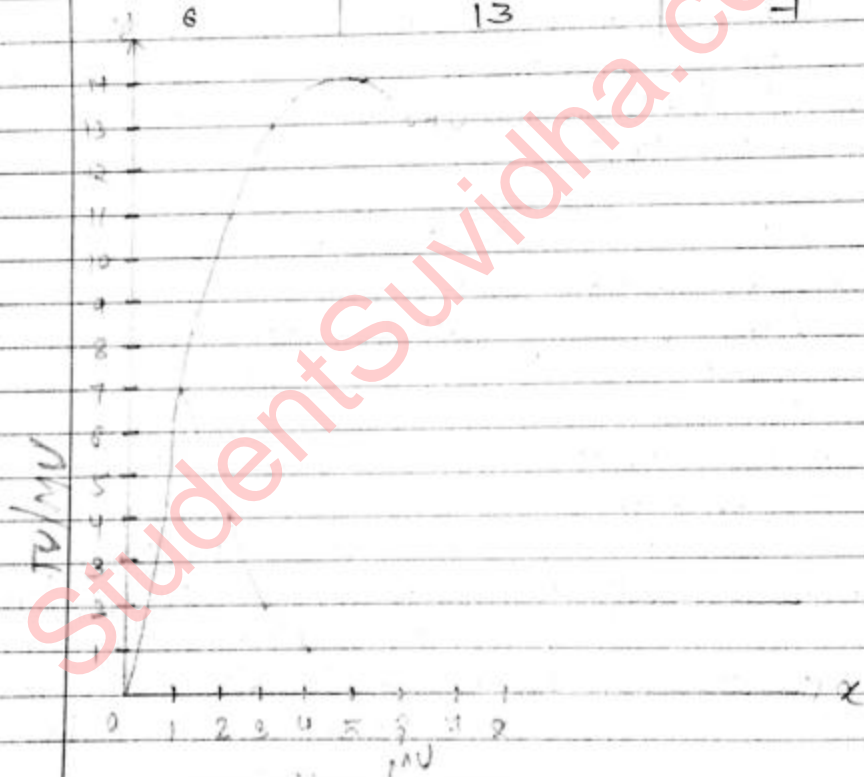
5. Bruce Janel
6. Rate of Interest
7. Expected future Income
8. Other [Advertise, weather, location etc.]
19. Savings - It is that portion of disposed income which is not spent on consumption of goods.  

$$\text{Saving} = \text{Income} - \text{Consumption}.$$
20. Income - The net inflow of cash or cash equivalent received from work over a certain period i.e. Rent (land), Wages or Salary (Labour), Interest (Capital), Profit (Enterprise).
21. Wealth Income - Wealth is a stock of goods owned at a point of time where as income is a flow i.e. In flow of money [all purchasing power] over a period of time.
22. Consumer Surplus - According to Marshall, "the excess of the price which a consumer would be willing to pay rather than forego without the benefit over that actually paid" is the measure of this surplus factor. It may be called consumer surplus.  
 Consumer Surplus - Price actually paid by the consumer - the price he/she is willing to pay.
23. Law of Marginal Diminishing ~~utility~~ utility - It is the fundamental law of economy based on the satiability of a particular wants. This law states that as a man gets more and more units



of commodity MU from each successive unit go on falling till it becomes zero or negative.

units of Apple	TU (utils/Day)	MU (utils/Day)
1	7	7
2	11	4
3	13	2
4	14	1
5	14	0
6	13	-1



Apple consumed

This law doesnot apply on article is like gold, money, music, hobbies and Also. MU may be affected by the presence or absence of article which are substitute or complements.

Q11. Demand forecasting - Since there is time <sup>gap</sup> b/w prodn and marketing. So the prodn is done on the basis of anticipation or demand forecasting. The success of a business firm depends to large extent upon its successful forecasting. It can be done through:-

1. Expert opinion method - Experts or specialists are consulted for their opinion regarding future for a particular commodity.
2. Survey of buyers intention - Generally a ~~buyer~~ limited no. of buyers choice and preference are surveyed and on the basis of that the business man forms an idea about future demand for the product it is going to produce.
3. Collective Opinion method - The firm seeks opinions of retailers & wholesalers in their respective territory with the view to sales.
4. Control experiment - The firms take into account certain <sup>factor</sup> that effect demand like price, advertisement, packing etc. on the basis of these determinant of demand the firms make an estimate about the future demand.
5. Statistical method - More often firms make statistical calculation about the trend of future demand. Statistical method comprising trend projection method, least squares method, regression, analysis etc are used depending upon the availability of statistical data.

### 1.3 DEMAND

The amount of a particular good or service that a consumer is willing to buy at a given price is called a demand.

#### Law of Demand

All other factors (Ceteris - Paribus) being equal as the price of good or service increases the consumer demand for the goods & services will decrease & vice-versa.

states that other things remaining unchanged, the quantity demanded of a commodity is inversely related to its price.

#### Assumptions of law of demand

- 1) Income of the people remaining unchanged.
- 2) Taste, preference and habits of consumers unchanged.
- 3) Prices of Related goods i.e. substitute and complementary goods remaining unchanged.
- 4) There is no expectation of future change in price of the commodity.
- 5) The commodity in question is not consumed for its prestige value.

#### Importance of law of Demand

1. Basis of demand - It results from the fact that consumption of additional unit of commodity produces the marginal utility to him.
2. Basis of Consumption Expenditure - It provides the basis for how the consumer should spend his income on the purchase of various commodities.
3. Basis of progressive taxation - It implies that MU to rich man is lower than a poor man (In progressive taxation the rate of tax increases).



with the increase in income).

4. Diamond-Water Paradox - Since the supply of water is a very low and the supply of diamond is limit. So, MU of diamond is very high therefore the price of diamond is very high in comparison of water.

~~Some~~ Exceptions to the law of Demand

1. Demand for goods conferring social prestige (conspicuous goods) - These goods are those goods which are purchased to project the status and prestige of the consumer. E.g. Expensive car, Diamond Jewellery etc.
2. Giffen goods - These are those <sup>inferior</sup> goods on which consumer spend a large part of his income and demand for which falls with falls in their price. E.g. Coarse cereals (jowar & bajra), clothes etc.
3. Expectation of future rise and price (Share speculation -ve market) - When the price of commodity increase and a consumer expects a further rise in its price. They will try to store more and more quantity of the commodity. Therefore even though the price has increase the demand will increase instead of falling.
4. Change in fashion (Bandwagon effects or Bandwagon goods) - Here the demand will increase even when the price of the commodity increases. The consumer demand is affected by preference and taste of social class he belongs to. E.g. fashionable dress etc.
5. Veblen effect - Sometimes the consumer judges the quality of a product by its price. Some people believe that the highest price means better quality and vice-versa. So, the demand goes up with rise in price. E.g. branded consumer goods.
6. Emergencies - Law of demand may not hold true.

during emergencies like wars, farmers at such kinds consumer behave in an abnormal way. If they expect shortage of good they will buy and hoard goods even at high prices. On the other hand during depression they will buy less even at low prices.

### Demand Schedule

It is tabular statement that states the different quantity of commodity that will be demanded at different prices.

Demand schedule can be two types:-

1. Individual demand <sup>schedule</sup> - It shows the quantity of the commodity of one consumer or a particular household will buy at select prices.

Price of Mango	Quantity Demanded
2	15
3	12
4	10

2. Market demand schedule - It is the horizontal summation of individual's demand.

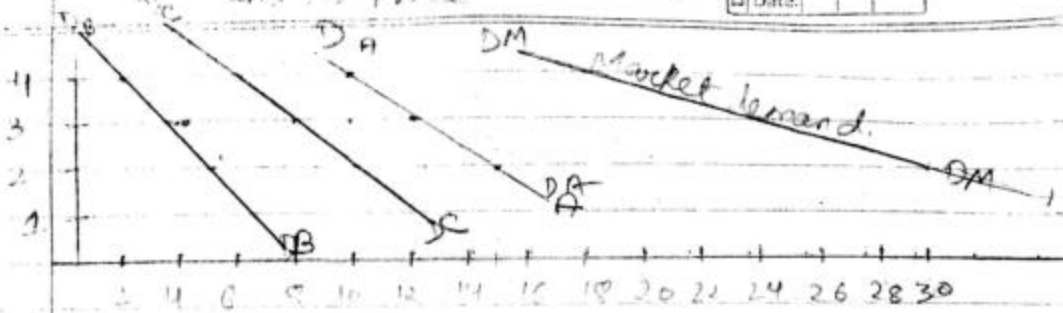
This is the aggregation of individual demand schedule.

Price	A	B	C	Market Demand
2	15	5	10	30
3	12	4	8	24
4	10	2	6	18

- ① Individual demand schedule is a tabular statement which shows different quantity of commodity that consumers would demand at different prices.

Demand curve is a graphical representation of the relationship between quantity demanded of a commodity and its price.

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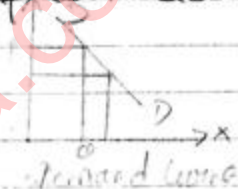
### Demand curve

It is diagrammatic representation of demand schedule.

### Determinant of demand

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1. Price of commodity
2. Income of the consumer
3. Consumer taste and preference.
4. Price of related goods
5. Consumer expectation.
6. Size and composition of population.



### Causes of downward slope of demand curve.

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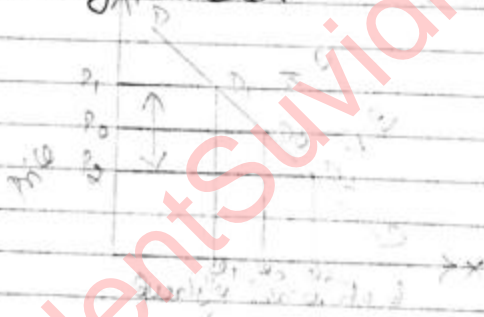
1. Law of diminishing marginal utility.
2. Income effect - change in demand on account of change in real income resulting from change in prices of a commodity is known as income effect.
3. Substitution effect - It is a change relative prices of substitute and complementary goods which changes quantity demanded.
4. Goods having no. of uses.
5. Change in no. of buyers.



### Movement along the demand curve

It is caused by change in only the price of goods other things remaining constant. It is also called change in quantity demanded.

1. Expansion of demand - It refers to rise in demand due to fall in price of goods. It is also called rise in quantity demand.
2. Contraction of demand - It refers to fall in demand due to the rise in price of goods other things the remaining constant. It is also called fall in quantity demand.



### Shift in Demand Curve

When the amount purchase of commodity rise or fall because of change in factor other than the price of the goods. It is called change in demand.

- 1) Increase in demand - It refers to a situation when a consumer buy large amount of commodity at a same price.

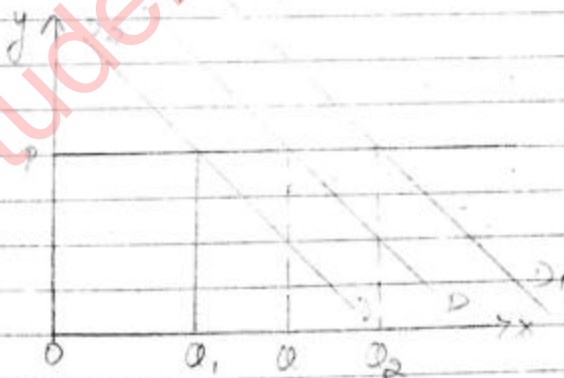
### Causes of Increase in demand

- 1) Increase in the income of consumer.
- 2) Increase in the price of substitute goods.
- 3) Fall in the price of complementary goods.
- 4) Consumers' taste become stronger in favour of goods.
- 5) Expectation of rise in price.
- 6) Increase in population.

- 2) Decrease in Demand - It refers to situation when a consumer buy a smaller quantity of a commodity at a same price.

### Causes of decrease in demand

- 1) Fall in the income of consumer.
- 2) Fall in the price of substitute goods.
- 3) Increase in the price of complementary goods.
- 4) Consumers' taste become unfavourable towards the good.
- 5) Expectation of fall in price.
- 6) Decrease in population.



## Elasticity of Demand

$$E_d = (-) \frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

$$= (-) \frac{\% \Delta \text{ in } Q}{\% \Delta \text{ in } P}$$

## Income Elasticity

$$E_y = \frac{\Delta Q}{\Delta Y} \times \frac{Y}{Q}$$

$$= \frac{\% \Delta \text{ in } Q}{\% \Delta \text{ in } Y}$$

For normal good +ve relation and for inferior good -ve relation.

## Cross elasticity

$$E_d = \frac{\Delta Q_x}{\Delta P_y} \times \frac{P_y}{Q_x} \quad (\text{substitute +ve})$$

$$= (-) \frac{\% \Delta \text{ in } Q_x}{\% \Delta \text{ in } P_y} \quad (\text{complementary goods } -ve)$$

## Elasticity of demand

It is defined as degree of responsiveness of quantity demanded of a commodity to a change in its price other factor remaining constant.



Coefficient of $E_d$	Types of $E_d$	Description	Type of goods	Shape of demand curve	Demand Curve
$E_d = 0$	Perfectly elastic demand	The Quantity Demanded does not respond to the change in Price.	Essential like life saving drugs	Vertical	
$E_d < 1$	Inelastic or less than unitary elastic	The proportionate change in quantity demanded is less than change in Price.	Necessity like food, fuel etc.	Steep	
$E_d = 1$	Unitary elastic Demand	1% change in Price = 1% change in quantity demanded	Normal good	45° demand curve forming 45° angle with both the axes	
$E_d > 1$	Elastic or more than unitary elastic	% change in quantity demanded is more than the change in Price.	Luxury like Car	Flat	
$E_d = \infty$	Perfectly elastic Demand	Infinite change in quantity demanded without any change in Price.	Imaginary situation	Horizontal	

## Determinant of price of elasticity of demand,

1. Nature of Commodity
2. Availability of substitute
3. Variety of Uses
4. Possibility of postponing of consumption.
5. Durable commodity.

## Importance of price elasticity of demand

1. Business Decision.
2. Importance to a monopolist
3. Determination of factor price.
4. Guidance for International trade.
5. Importance to Govt.

Q1 If the price falls from Rs 50 to Rs 48 the demand increase from Rs 100 to Rs 110. Calculate Price elasticity of demand.

Ans

P	Q
50	100
48	110

$$\begin{aligned}
 E_d &= (-) \frac{\Delta Q}{\Delta P} \times \frac{P}{Q} \\
 &= (-) \frac{10}{2} \times \frac{50}{100} \\
 &= 2.5
 \end{aligned}$$

Q2 The Income of the consumer increases from Rs 500 to Rs 600 resulting in an increase in quantity demanded to 10 units to 15 units Calculate  $E_y$ .

Ans

Y	QD
500	10
600	15

$$E_y = \frac{\Delta Q}{\Delta Y} \times \frac{Y}{Q}$$

$$= \frac{5}{100} \times \frac{500}{10}$$

$$= 2.5$$

Q3 If the price of coffee raise from Rs 100 per kg to Rs 125 per kg and consequently the demand for tea increase from 10 kg to 15 kg the cross elasticity of demand between coffee & tea Calculate  $E_c$ .

Px	QDy
100	10
125	15

$$E_c = \frac{\Delta Q_x}{\Delta P_y} \times \frac{P_y}{Q_y}$$

$$= \frac{5}{25} \times \frac{100}{10}$$

$$= 2$$



Q If the current demand of economics books 10,000 per year of publication house the Ed is 0.75 and the price increase 50 paise per book Calculate change in quantity of books demanded if the original price is Rs 1.50.

P QD  
1.50 x  
Q 10,000  
ed = 0.75

$$ed = \frac{\Delta Q}{Q} \times \frac{P}{\Delta P}$$

$$0.75 = \frac{10,000 - x}{10,000} \times \frac{1.50}{0.50}$$

$$0.75 = \frac{10,000 - x}{10,000} \times 3$$

$$3x = 10,000 - 0.75 \times 10,000$$

$$= 800$$

Q When the price of the commodity falls by 80%, the quantity demanded increase by 100%. Calculate ed.

Ans

$$Ed = \frac{\% \Delta \text{ in QD}}{\% \Delta \text{ in P}}$$

$$= \frac{100}{80} = 1.25$$

Q If the price of commodity falls from 2/unit to 5/unit the consumer demand increase from 10 units to 16 units. Calculate ed.

Ans

P	QD
2	10
5	16

$$Ed = (-) \frac{\Delta Q \times P}{\Delta P \times Q}$$

$$= (-) \frac{6 \times 2}{3 \times 10}$$

$$= \frac{12}{30} \times \frac{8}{105}$$

$$= 1.6$$

Q If the price of a commodity before & after inflation 5 & 8 respectively & corresponding demand 20 & 15 unit. Calculate ed.

Ans

P	QD
5	20
8	15

$$Ed = (-) \frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

$$= (-) \frac{(-5)}{3} \times \frac{8}{20}$$

$$= \frac{(-)(-5)}{3} \times \frac{5}{20}$$

$$= 0.4$$

- Q Given that the quantity demand previously demanded, 100 unit decrease in quantity demand is 5 unit & increase the price is 5 & ed is 1.2. Calculate the price before the change

$$Ed = (-) \frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

$$1.2 = - \frac{(-5)}{5} \times \frac{P_1}{100}$$

$$1.2 \times 100 = P_1$$

$$P = ₹ 120$$



- Q When Deepa income is 6000/month. she brought 4ltr of milk per month when her income increase to 8000/month she purchase 50 litre compute ~~income~~ <sup>income</sup> ~~ex~~ <sup>ex</sup>.

Ans

Y	Q
6000	40
8000	50

$$\begin{aligned}
 e_y &= \frac{\Delta Q}{\Delta Y} \times \frac{Y}{Q} \\
 &= \frac{10}{2000} \times \frac{8000}{40} \\
 &= 0.75
 \end{aligned}$$

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## \* Supply

- Q1 Given  $e_s = 5$  original price Rs 60 & new price Rs 100  
change in quantity doesn't find the original  
quantity & New quantity  
[ $Q - 60 = 100$ ]
- Q2 The coefficient of good is 8 a seller supplies  
36 unit of good at a price Rs 6 per unit  
How much ~~of~~ <sup>quantity</sup> ~~these~~ <sup>of this good</sup> quantity will this seller  
Supply when the price rises by Rs 10 per unit.  
[Ans 22]
- Q3 A good has a unitary elastic supply if the  
producer sell 40 units of that good at a  
price of 2 How much he willing to sell  
at the price of 3.  
[Ans 60]
- Q4 Price of good falls from Rs 15 to Rs 10 and  
Supply decreases from 100 units to 50 units  
Calculate  $e_s$ .  
(Ans - 1.5)
- Q5 Given  $e_s = 2$  a producer sell 10 unit of a good  
at Rs 4 How much will he willing to sell  
at a price of 5/unit?  
(Ans - 15)
- Q6 A 15% rise in the <sup>Price</sup> ~~Supply~~ of commodity results  
in rise in its supply from 100 to 135 unit  
Calculate  $e_s$ .  
( $e_s = 1.5$ )

1.  $ES = 5$   
 $P \quad Q$   
 $60$   
 $100$

$$\Delta q = 20$$

$$ES = \frac{\Delta q}{\Delta P} \times \frac{P}{q}$$

$$5 = \frac{26}{46} \times \frac{30}{q}$$

$$5q = 30$$

$$q = 6$$

$$q_1 = 26$$

Q2  $ES = 8$   
 $P \quad q$   
 $6 \quad 36$   
 $10 \quad ?$

$$ES = \frac{\Delta q}{\Delta P} \times \frac{P}{q}$$

$$8 = \frac{\Delta q}{4} \times \frac{6}{36}$$

$$8 \times 24 = \Delta q$$

$$192 = \Delta q$$

$$q_1 = \Delta q + q_2$$

$$= 192 + 36 = 228$$



Q3

P	Q	P	Q
40	2	2	40
		3	

$$e_s = \frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

$$1 = \frac{\Delta Q}{1} \times \frac{2}{40}$$

$$20 = \Delta Q$$

$$Q_1 = \Delta Q + Q$$

$$= 20 + 40$$

$$= 60$$

Q4

P	Q
15	100
10	50

$$e_s = \frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$$

$$= \frac{100 - 50}{15 - 10} \times \frac{15}{100}$$

$$= \frac{3}{2} = 1.5$$

Q5

$$e_s = 2$$

P	Q
4	10
5	2

$$ES = \frac{\Delta q}{\Delta p} \times \frac{p}{q}$$

$$2 = \frac{\Delta q}{1} \times \frac{12}{10.5}$$

$$\frac{2 \times 5}{2} = \Delta q$$

$$5 = \Delta q$$

$$q = 15$$

Q6

P	q
15%	600
	735

$$ES = \frac{\% \text{ change in quantity supply}}{\% \text{ change in price}}$$

$$\frac{735 - 600}{600} \times 100$$

$$15$$

$$= \frac{135}{600} \times 100$$

$$15$$

$$= \frac{22.5}{15} = 1.5$$

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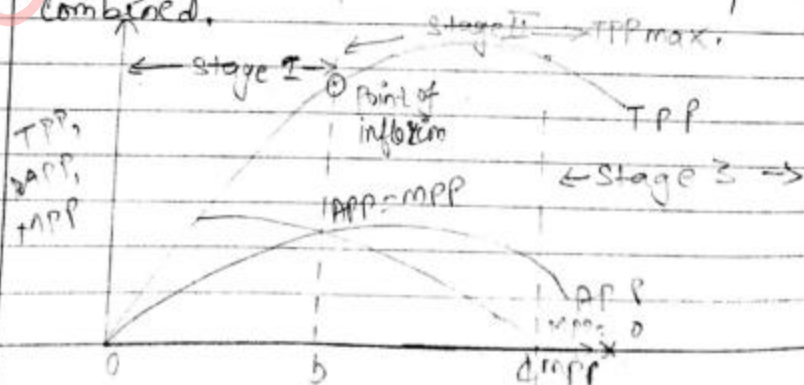
## Law of Variable proportion

Law of variable proportion is widely observed law of prodn which takes place in short run. This law is formulated by Joan Robinson. It is also called law of non-proportional return or law of Diminishing marginal return or law of return to a factor.

It states that when the total output or prodn of a commodity is increased by adding units of variable input while the quantities of other inputs are held constant, the decrease in total <sup>prodn</sup> <sup>after some time</sup> becomes smaller & smaller.

## Assumption

1. State of technology remains the same.
2. All units of variable factors are homogenous.
3. They must always be some fixed input which cannot be increased in short term.
4. Only one factor is variable & the other ~~factor~~ <sup>factor</sup> is constant. It is possible to vary the proportion in which the various inputs are combined.





STAGES  
increasing  
acceleration

Term used

Increasing returns  
to a factor

TP

Start from the origin  
Increase at increasing rate  
& then increase at  
diminishing rate

AP

Start from the origin  
Increase at increasing rate  
& then increase at  
still its maximum pt

MP

Increases and  
reaches at  
maximum

Reference Point  
from O to b

II

Diminishing return  
to a factor

Increases at a slow  
rate till it  
reaches at maximum pt

become equal to MP  
& then begins to  
diminish

falls continuously  
till it equal to  
zero

from D to d

III

-ve return to a  
factor

falls

falls continuously

It is -ve

pt of increase

### Stage of increasing return

In stage I total product is not fully utilised. The quantity of the fixed factor is too much relative to the quantity of the variable factor so that a some of the fixed factor withdrawn the total product would increase.

This in the I stage MP of fixed factor is -ve. No rational producer will choose to produce in this stage even if fixed factor was nothing. Producer can expand prodn by increasing quantity of variable factor & make efficient use of fixed factor.

### Stage of Diminishing Return

In stage 2 the total product continues to increase at a diminishing until it reaches its max. pt. where the II stage end. In this stage both the AP & MP of the variable factor are diminishing (but not -ve) & the latter falling at a faster rate that is why this stage is known as stage of diminishing return with falling AP curve. Efficiency of the variable factor decrease & that on the variable factor continue to rise the AP of the variable factor exceeds the MP of the factor & throughout the stage. This stage is very crucial it is the stage of operation. A rational producer will always seek to produce in this stage where both AP & MP are falling.

### Stage of -ve Return

In stage 3 total product declines so the MP of the variable factor become -ve & falls below

Decline in total product

$x$  axis. This stage is called stage of -ve returns. TP, AP & MP fall during the Stage II. AP of the variable factor is non -ve. In this stage efficiency of variable as well as fixed factor declines & the factor ratio is highly suboptimal. Producer should reduce the amount of variable factor.

### Stage of operation

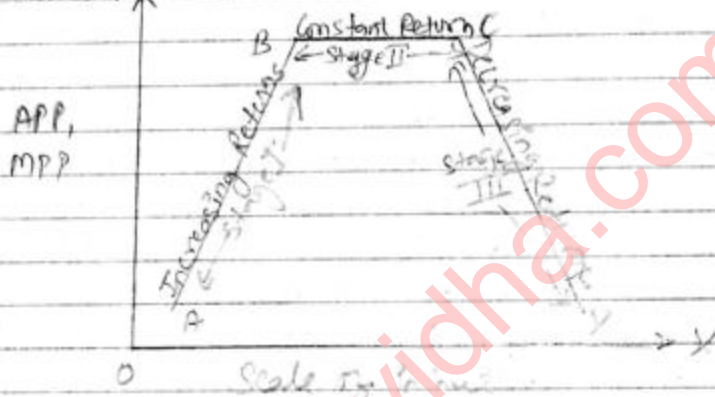
A Rational producer will never choose to produce in Stage I & III both of these stages are called stages of economic absurdity or economic nonsense. These stages represent non-economic regions in the prodn function. Stage II represent range of rational prodn decision. The particular  $P_t$  of production depends upon the prices of the factor. The producer will employ additional units of variable factor till its marginal revenue  $P_t$  become equal to marginal cost. The lesser the price of the fixed factor relative to that of variable factor (due to relative scarcity of variable factor). The chosen  $P_t$  of prodn will be closer to the beginning of the stage II & vice-versa.

In extreme case where the fixed factor is cost less & the variable factor is paid less the firm will choose to produce at that  $P_t$  where the stage II begin similarly when the variable factor is available free of cost & fixed factor is to be paid for the firm will choose to produce at the  $P_t$  where the stage II end.



## Law of Return to Scale

It states that when all factor of production are increased in the same proportion the output will increase but the increase may be at increasing rate, constant rate or diminishing rate.



### Increasing return to scale

It occurs when the increase in output is more than proportional to increase in input.

The first stage starts from the point of origin & continues still the APP is maximum.

### Constant Returns to Scale

It occurs when the increase in output is proportional to the increase in input.

### Decreasing return to scale

It occurs when the increase in output is less than proportional to increase in input.

STAGES	Term used	TP	AP	MP	Reference Point
I	Increasing return to scale at an increasing rate	It increases	It rises rapidly	Economy is off a scale	a to b
II	Constant return to scale	It increases at a constant rate	Constant	—	b to c
III	Decreasing return to scale at a decreasing rate	It increases	falls rapidly	Diseconomy is off a scale	c to d

### Causes

Scale of Input	TP	MP	
1L + 1K	10	10	Stage I
2L + 2K	30	20	
3L + 3K	60	30	
4L + 4K	100	40	Stage II
5L + 5K	140	40	
6L + 6K	180	40	
7L + 7K	210	30	Stage III
8L + 8K	230	20	
9L + 9K	240	10	

### Causes of Increasing Return

- ① Indivisibility of Factor - Indivisibility means that certain factors are available only in large lumpy units and can therefore be utilised utmost efficiency at a large level of output as the scale of prodn increases these indivisible factors are utilised better and more efficiently this leads to increasing returns to scale.

- ② Division & Specialisation of Labour - As the no. of variable factor is increased in the stage I the efficiency of the variable factor itself increases this is because of division of labour or specialisation with more labourer (variable factor) it is possible to divide the work among the labourers according to their skill & aptitude this results in specialisation & increase in efficiency.



### Causes of Decreases Return

1. Entrepreneur as a fixed factor - Some economic cause of the various that the entrepreneur is the factor of prodn. an increase in the scale may come to a point where the availability ability & skills of the entrepreneur may be fully utilised and increase in scale beyond this point may decrease the efficiency of the entrepreneur this gives rise to diseconomy of scale.
2. Management Problem - Used too much of variable factor like labour also create a problem of effective management when there are too many workers they may shift their responsibility to others. It becomes difficult to manage then labourers can avoid works all this leads to decrease in efficiency.
3. Exhaustibility of natural resources - Another factor responsible for diminishing return in some activities is limitation of natural resources.

Labour & Capital	TP	AP	MP
1	8	8	8
2	14	7	6
3	18	6	4
4	20	5	2

Q2	Units of labour	TP	MP	AP
	1	20	20	20
	2	30	15	15
	3	45	15	15
	4	70	25	17.5
	5	100	30	20
	6	130	30	21.6
	7	160	30	22.8
	8	180	20	22.5
	9	195	15	21.6
	10	200	5	20

Also divide in Three stages

## COST

1. Real Cost - Real cost of prodn is the pain, sacrifice or discomfort face by the labour during producing the commodity. It is the subjective concept & cannot be measured accurately.
2. Explicit cost - Explicit cost or direct cost is the actual expenditures incurred by a firm to purchase or hire the input in the prodn process. These include wages & interest.
3. Implicit cost or imputed cost - It refers to the imputed (estimated) value of the inputs owned by the firm and use by it in its own prodn unit. It is the cost of input incurred by firm in its own prodn process. It is not

Payment for old premises & self invested capital.

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9/Sept/11

CRR - 6%

SLR - 24%

Bnk Rate - 6%

### \* Repo Rate

The Rate at which RBI lends to Commercial bank and it is short term loan.

<sup>Now-a-days</sup>  
~~Today~~ Repo Rate is 8%

### \* Inverse Repo Rate

The Rate at which RBI borrows the money from commercial bank and it is short term loan.

<sup>Now-a-days</sup>  
~~Today~~ Inverse Repo Rate is 7%

Savings Rate - 4%

Deposit Rate - 8.5-9.5%

### \* Hundi

A negotiable instrument written in an vernacular (regional) language.

### \* Underwriters

An investment bank that act as a intermediary b/w the issuing company & investors who purchase the companies debt instrument.

### \* Unlimited legal tender

Payment which can be made upto any extent.

## MEC (marginal efficiency of Capital)

MEC is measured on the basis of comparison of supply price for the present value of the capital good and the demand price for the future value of the capital good. The Future Value is what the Capital good will yield in its life time and that value is discounted at the present rate of interest in order to make it comparable with the present value of capital good. <sup>Thus</sup> it is the highest rate of return expected from an additional unit of a capital asset over its costs. It is also known as internal rate of return.

## Annuity/Annuities

It is the annual return or income flow expected from the asset during its life time.

Suppose that a purchase price of a machine is Rs 4973.70. The machine has a life of 3 years and the annual income it can yield is Rs 2000. What rate of discount will make annual flow of Rs 2000 each for 3 years equal to the purchase price of Rs 4973.70?

Ans 
$$C = \frac{R_1}{(1+i)^1} + \frac{R_2}{(1+i)^2} + \frac{R_3}{(1+i)^3}$$

$$4973.70 = \frac{2000}{(1+i)^1} + \frac{2000}{(1+i)^2} + \frac{2000}{(1+i)^3}$$

It is Advantages rate of return expected from  
from capital <sup>asset</sup> ~~asset~~ if it exceeds market rate of  
Interest.

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27/Sept/11

MCCQ

1. (a) Lionell ~~Rob~~ Robbins
- (b) Income of the consumer
- (c) elastic demand
- (d) Taste & preference of the consumer
- (e) oligopoly
- (f) AR
- (g) Real GNP Per Capita
- (h) Malthusian theory
- (i) Irwin Fisher
- (j) Central bank

1. (b) fill up

- a) moral suasion
- b) quantitative techniques
- c) 1949
- d) Deflation
- e) MEC
- f) Unfavourable
- g) Savings
- h) Voluntary
- i) Autonomous
- j) mps
- k) Price Discrimination
- l) Supernormal profit
- m) External
- n) Law of Increasing return to Scale
- o) TVC

T/f

1. T
2. f
3. f
4. T
5. F
6. f
7. f
8. T
9. T
10. f
11. T
12. f
13. f
14. f
15. T

Q5 MCQ

- a) Joint hindu family
- b) Producers Cooperative

fill up

- a) Partnership
- b) Sole proprietorship

T/f

- a) T
- b) f

2/10/21

## PUBLIC FINANCE

### Direct tax

- | Direct tax (Personal taxation)   | Indirect tax (Commodity taxation)                                 |
|--|---|
| 1. The Tax payer and the tax bearer are one and same person.                         | 1. The tax payer and the tax bearer are different person.         |
| 2. Impact and incident are on one & same person.                                     | 2. Impact and incident are on different persons.                  |
| 3. Burden can't be shifted.  | 3. Burden can be shifted.   |
| 4. Intention of the legislature is that the burden should not be shifted.            | 4. Intention of the legislature is that burden should be shifted. |
| 5. Example - income tax, wealth tax, property tax, Profi tax, Capital gains tax etc. | 5. Example - Custom duties, excise duty, sales tax etc.           |

### Canons of taxation

1. Canon of equity  
It is also called ability to pay principle. It means that taxes should be imposed on the people according to their capacity to pay the taxes. The objective of this canon is equal sacrifice by each tax payer. This canon involves the principle of justice or equity in taxation.
2. Canon of certainty  
The Canon of certainty demands that there should be no element of arbitrariness.



In a tax, The tax payer should be able to see ~~what~~ for himself why he is called to pay a particular sum. Certainty is needed not only from the point of view of tax payer but also from the ~~straight~~ <sup>gvt.</sup> the gvt. should be able to estimate ~~with~~ <sup>roughly</sup> the proceed of the various taxes proposed to be levied and the time when they are expected to flow in. Only then the gvt can follow its financial programs. This canon is meant to prevent the exploitation of the tax payer.

### 3. Canon of Convenience

The objective of this Canon is to reduce psychic burden and inconvenience of pay the tax. Income tax is usually collected at source. Sales tax ~~tax~~ is collected at the time of sale of the commodity & the <sup>agricultural</sup> ~~cultural~~ income tax is collected after the harvest season. All these are done to make tax payment convenient & less burden some tax payer.

### 4. Canon of economy

This Canon signifies the ~~least~~ <sup>cost</sup> ~~cause~~ <sup>of</sup> collecting the revenue should be kept at the minimum possible value. The tax laws & procedure should be simple so people can easily understand then an might not have to incurred the expense to maintain their A/c & fill in the tax returns.

## International Trade

BOP	BOT
1. BOP is the Broad term and include balance of trade	1. It is a narrow concept & a part of BOP.
2. It include all type of item i.e. Visible as well as invisible	2. BOT includes Imports & export of goods alone that is visible item
3. It always balances.	3. It can be favourable or unfavourable.
4. Deficit of BOT can be <del>met</del> meet by BOP.	4. Deficit of BOP can't be met by BOT
5. It is more significant than BOT	5. It is less significant than BOP

### BOP A/c

Credits(+) (Receipts)	Debits (-) (Payments)
1. Current A/c	1. Current A/c
- export	- Imports
a) goods	a) goods
b) Service	b) Service
c) transfer payment	c) Transfer payment
2. Capital A/c	2. Capital A/c
Lending to foreign countries	a) Borrowing from foreign countries
Direct investment in foreign countries	b) Direct investment By foreign countries

3. Officials Settlement Ac

- a) Increase in official  
reserve of gold  
& foreign currency

3. official settlement Ac

- a) Increase in foreign  
official holdings

4. Errors & omission

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Economics and Business fundamentals time = 3hrs  
M.M = 100

4 marks

Economics 6 marks Business fundamentals

Q1. Compulsory 36 marks Q5. Compulsory 24 marks

- a) MCQ (1x9 = 9)  
b) fill up (1x12 = 12)  
c) TLF (1x9 = 9)  
d) Definition (1x6 = 6)

- a) MCQ = 1x6 = 6  
b) fill up = 1x6 = 6  
c) TLF = 1x6 = 6  
d) Definition = 1x6 = 6

Q2. Short notes 4x3 = 12  
Q3, 4 (12 marks each)

Q6 Short notes  
Q7, Q8 (8 marks each)

X X X X X X

- \* Wealth definition - Adam Smith  
Welfare definition - Alfred Marshall  
Scarcity definition - Robbins  
Growth oriented definition - Paul A Samuelson

\* A mixed economy is <sup>an</sup> ~~the~~ economy which combine <sup>the</sup> element of both Capitalistic and Socialistic economics.

A mixed economy is characterised by <sup>coexistence of</sup> both private sector and public (government) sector. On the one hand private sector operate by market or price mechanism. On the other hand the government controls and regulate the working of the private sector or ~~participates~~ in the production process.



Portfolio Investment

Consumer Surplus

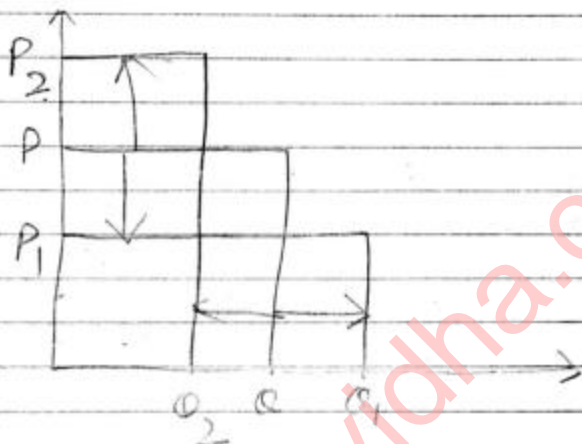
Application of the concept of opportunity cost

for the proportional, progressive & regressive taxation?

Pg - 198 principle

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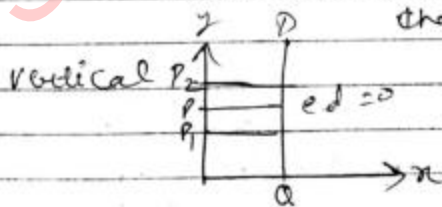
Law of demand states that other thing remaining unchanged, the quantity demanded of a commodity is inversely related to price of commodity.



Elasticity of demand:-

It is defined as degree of responsiveness in quantity demanded due to a commodity due to change in its price other factors remaining constant.

$e_d = 0$  Perfectly inelastic demand. Essential like saving drugs. Elastic demand does not respond to change in price.



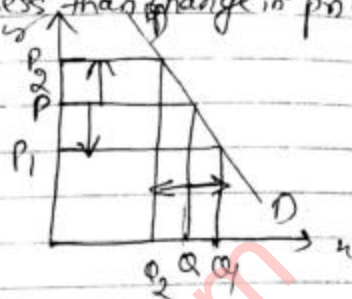
ed less than 1

Inelastic or less than  
Unitary elastic

Proportionate  
The change in quantity demanded  
less than change in price

Necessities goods  
like food, fuel etc

Steeper

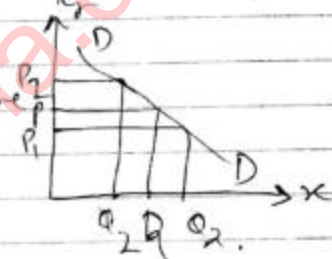


ed = 1 Unitary elastic  
demand

% change in price = % change in demand

Normal goods

Linear demand curve  
forming 45° from  
both axes



ed greater than 1

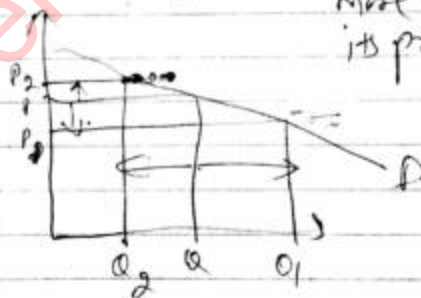
ed > 1

Elastic or  
more than unitary elastic

The proportionate change  
in quantity demanded  
more than change in  
its price

Luxury  
goods

flatter



ed = ∞

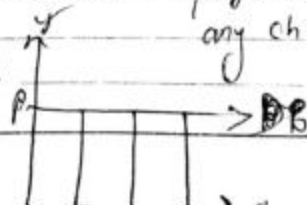
perfectly elastic  
demand

Infinite change  
in quantity demanded

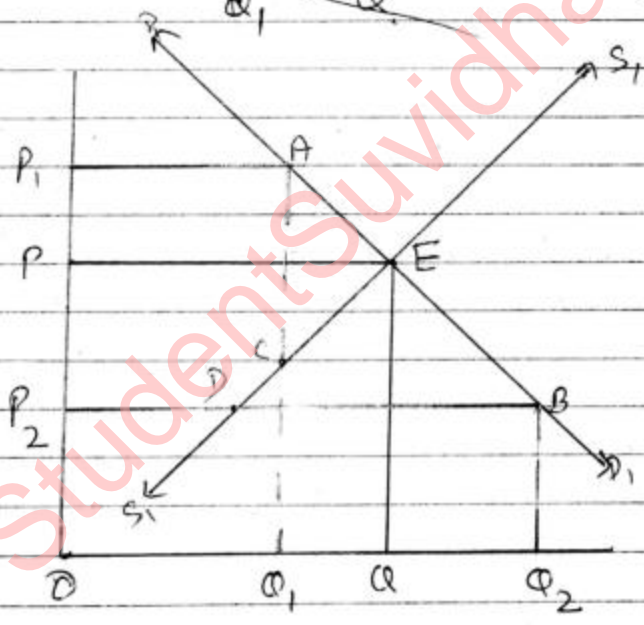
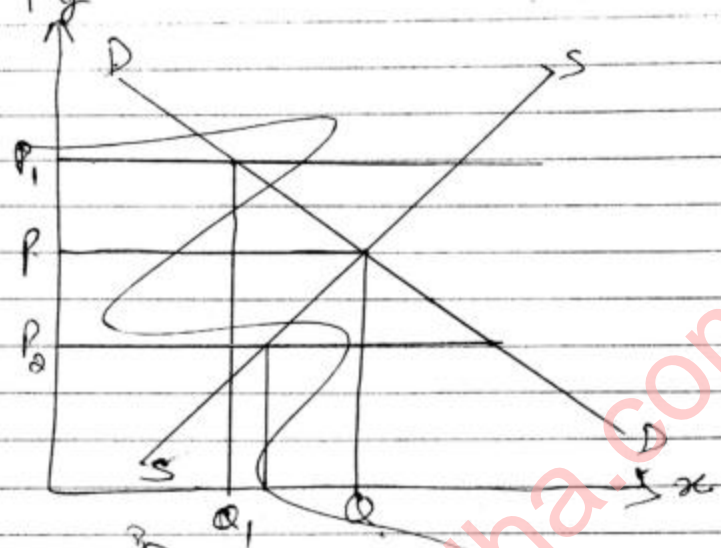
without  
any change in price.

Imaginary  
situation

Horizontal

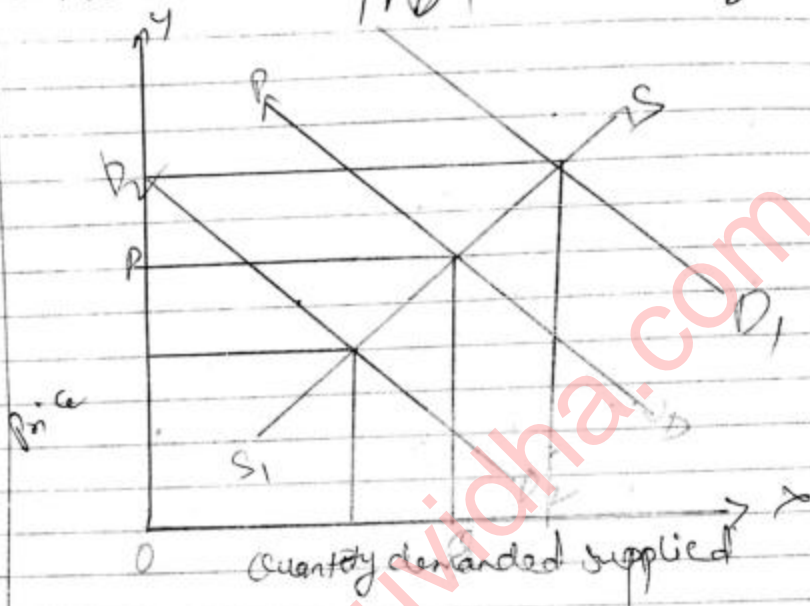


Equilibrium

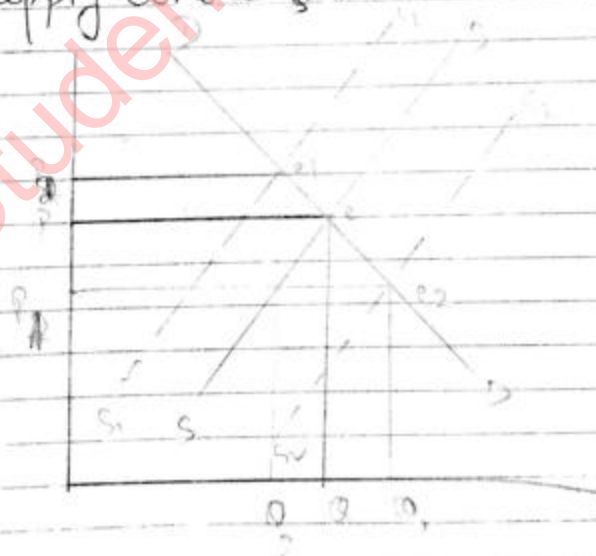




change in equilibrium price due to shift in demand the supply, remaining constant

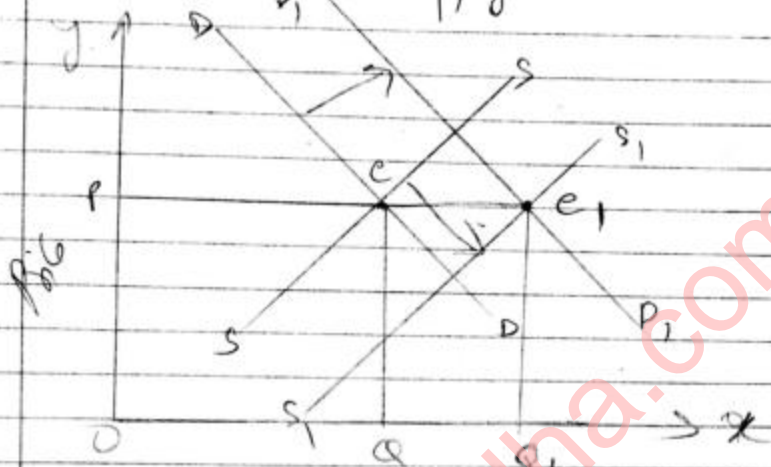


change in equilibrium price due to shift in supply where demand remain constant



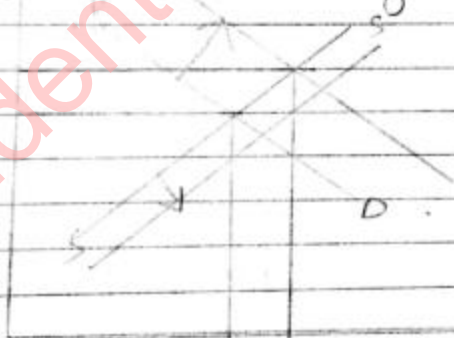
change in equilibrium price due to shift in both demand & supply

(1)

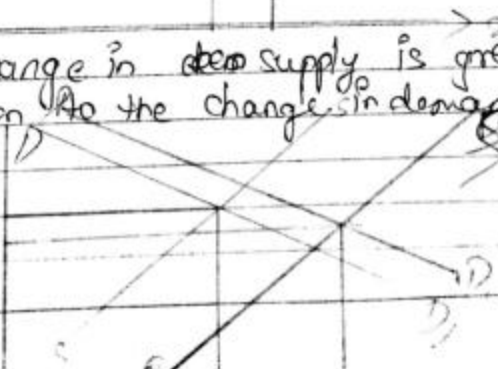


(2)

(2) If the change in demand is greater than in proportion to the change in supply



(3) If the change in ~~dem~~ supply is greater than is proportion to the change in demand,



### Short period

The time period during which a firm is order to ~~make~~<sup>change</sup> its production can change only its variable factor ~~it term~~ but not in its fixed factor is termed as short-period.

In the short period firm cannot change its scale of plant.

### Long Period

The time period during which a firm can change ~~its~~ all <sup>the</sup> factor of prodn and its scale of plant is called long period.

### Total product

It refers to the total output of the firm per period of time.

### Average Product

It ~~refers to~~<sup>is the</sup> total output per unit of the variable input.

$$AP = \frac{Q}{L} \quad Q = \text{Total Product} \quad L = \text{Quantity of labour.}$$

### Marginal Product

Marginal product is the change in total product resulting from using additional unit of variable factor.

$$MP = \frac{dQ}{dL} = d \quad \text{is the rate of change}$$

## Law of variable proportion

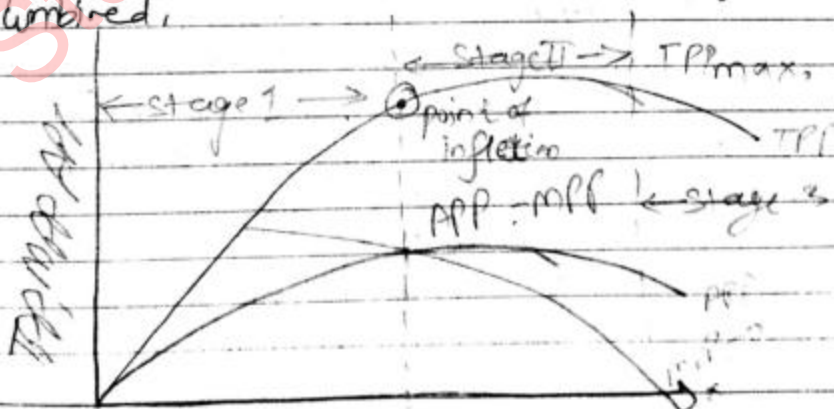
Law of variable proportion is widely observed in the law of production which takes place in short run. This law is formulated by Joan Robinson. It is also called law of non-proportional return, law of diminishing marginal returns or law of return to a factor.

It states that when the total output or production of commodity is increased by adding unit of variable factor input while other factors are held constant, increase in the total production becomes after some time smaller & smaller.

### Assumptions

- ① State of technology remains the same.
- ② All units of variable factor are homogeneous.
- ③ They must always be some fixed input which cannot be increased in short term.

Only one factor is variable & other factors are constant. It is possible to vary the proportion in which the various inputs are combined.





### Stage of Increasing Return

In stage I Total product is not fully utilized. The quantity of fixed factor is so much relative to the quantity of variable factor. So that a some of the fixed factor withdrawn the total output increase.

Thus in stage I MP of fixed factor is negative. No rational producer will choose to produce in this stage even if the fixed factor was nothing produced can expand production by increasing the quantity of variable factor & make efficient use of fixed factor.

### Stage of Diminishing Return

In stage 2 total product will continuously increase at decreasing diminishing rate until it reach its maximum point. In this stage both AP & MP are diminishing (but not -ve). A later falling at a faster rate that is why this stage is known as stage of diminishing return. With falling AP curve the efficiency of variable factor decrease and that on the variable factor to rise. The AP of the variable factor exceeds the MP of the variable factor throughout the stage. This stage is very crucial it is the operation of law of stage of operation. A rational producer is always seek to produce in this stage where both AP & MP are falling.

### Stage of Negative Return

In Stage III total product decline and so the MP of the variable factor <sup>MP</sup> become <sup>MP</sup> and fall below x-axis. This stage is called stage of -ve return. TP, AP and MP falls during this stage. An AP of the variable factor is non-re. In this stage efficiency of variable factor as well as fixed factor ~~is~~ declines and the factor ratio is highly suboptimal. The producer should reduce the <sup>amount of</sup> variable factor.

### Stage of operation

A rational producer will never produce in Stage I & III. This stage represent the ~~none ec~~ <sup>These stages represent non-economic region in</sup> <sub>production function</sub>

### Stage of Operation

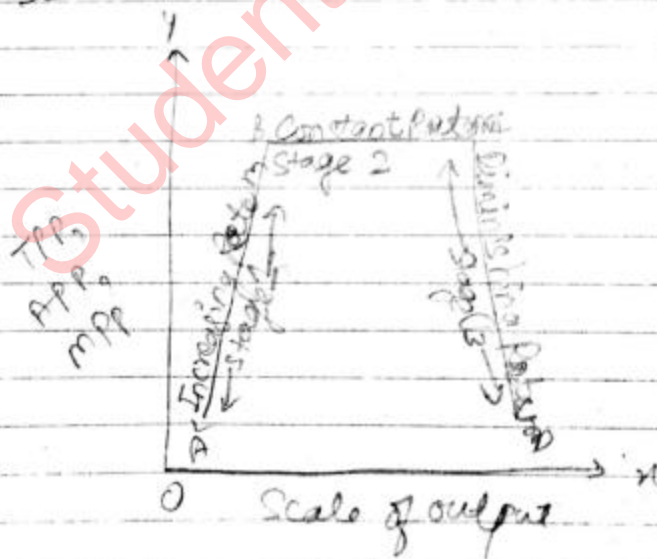
A rational producer will never produce in Stage I & III both of these stage are called Stage of economic absurdity and economic non sense. Stage II represent the range of rational production decision. The particular point of production depends upon the price of factors. The producer will employ additional unit of variable factor till its marginal revenue product become equal to marginal cost. The lesser the price of fixed factor relative to that of variable factor. The chosen point of production will be closer to beginning of the Stage II.

In extreme cases where ~~fixed~~ <sup>factor</sup> factor is cost less and variable ~~is~~ <sup>factor</sup> paid less the firm will choose to produce at that point where stage II ends ~~when~~ <sup>begin</sup> similarly where ~~fixed~~ <sup>factor</sup> factor is.

Stage II begins similarly when variable factor is available free of cost and ~~fixed~~ <sup>fixed</sup> factor is to be paid for the ~~fixed~~ <sup>fixed</sup> factor. The ~~best~~ <sup>best</sup> firm will choose to produce at that point where stage II ends.

### Law of return to Scale

It states that <sup>when</sup> all the factor of production increase in the same proportion the output will increase but increase ~~may be~~ <sup>may be</sup> increasing rate, constant rate, & diminishing rate.





Distinction b/w Return to a Variable factor (or Law of Variable proportion) and Return to Scale.

Return to a Variable factor

1. Operates in the short-run or it is related to short-run prodn function.
2. Only the quantities of a variable factor are varied.
3. There is ~~no~~ change in the factor proportion.
4. No change in the scale of prodn because here all factor inputs are not changed.

Return to Scale

1. Operates in the long run or it is related to long-run prodn function.
2. All factor inputs are varied in same proportion.
3. There is no change in factor ratio.
4. There is change in the scale of prodn because all the factor inputs are varied in the same proportion.

Cost

Cost is the expenditure which a firm incurs in production of a given level of output.

Rec



## Taxation

A tax is a compulsory contribution collected from citizens for which the tax payer cannot expect any *quid pro quo* i.e. direct ~~tax~~ benefit from the payee. It is compulsory in nature and absence of benefit to payers are two features by which taxes differ from non-taxes revenue like fee & fines etc.

Taxes are used for ~~the~~ bringing distributive justice, controlling inflation, achieving full employment, curbing consumption etc.

### Deficit financing

When the Government expenditure exceeds the government revenues from taxes, profit of public undertaking, borrowing from the public etc. it results to deficit financing.

Deficit financing involves either drawing down of cash balance of the Government held in the central bank or by borrowing from the central bank. When the govt. borrows from the central bank, the central bank issues notes and give them to the government against government security.

In any developing economy the needs for raising resources for development far exceeds the resource raise through taxation & borrowing etc. This gap has to be met by deficit financing. Deficit financing is very useful resource. It helps in fullest exploitation of unused resources.

The unutilised human and non-human resource can be utilised for productive purpose with the help of deficit financing.

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## Sole proprietorship

Sole proprietorship refers to that form of business organ which is owned by a single individual, who is solely responsible for its management and receives all profit and losses. The sole proprietorship form of business is generally operated on a small-scale basis.

## Money

### Quantity theory of Money

QTM states that there is direct relationship b/w the money in the economy and level of price of goods & services sold. Acc. to QTM if the amount of money in an economy double price level also double cause inflation. The consumer therefore pay twice as much for the same amt of goods & service.

Another way to understand this theory is to recognize that money is like any other commodity. Increase in its supply decrease its marginal value. So an increase in money supply causes price to rise as they compensate for the decrease in money's marginal value.

### The theory Calculations

In its simplest form, the theory is expressed as

$$MV = PT \text{ (the fisher eqn)}$$

each variable denote the following

M - money supply

V - Velocity of circulation



$P$  = Avg price level  
 $T$  = Volume of transaction of goods & services  
 This theory

The original theory was considered orthodox among 17th century classical economists and was overhauled by 20th-century economists Irving Fisher, who formulated the above eqn & Milton Friedman

### QTM Cash Balance Approach

This theory given by Alfred Marshall.

The Cash balance approach states that it is not total money but the part of the money people spend that influences the price level. True, people hold cash balance in their hand instead of spending the entire amount all at once. The reqn is  $M = PKT$

$M$  = stock of money

$P$  = price level

$K$  = amt of purchasing power at which the people wish to retain

$T$  = Trade transaction

Diff between QTM & CBM • Fisher's QTM & Cambridge QTM  
 ① Demand for money is to exchange goods. People demand money only for transaction only. ① The demand for money is primarily as a store of value

② Value of money is at a point of time ② Value of money for a period of time

③ Emphasis is on velocity of circulation of money ③ Emphasis is on idle cash balances represented a part of the total income



- (4) Fisher has given micro economy. (5) Alfred has given macro economy.

### Quantity theory by Keynes

In Keynes opinion the quantity of money does not directly affect price level. But it does indirectly through ~~and~~ a long process of event. A change in the quantity of money may lead a change in ~~per~~ rate of interest and with change in rate of interest the volume of investment is quite likely to change. A change in investment will lead to a change in income, output <sup>and also change in</sup> cost of prodn. This will lead to the change in price ~~level~~ of goods & service employment.

### Inflation

It is an overall change in general price <sup>level</sup> of the goods and services within an economy.

The cost structure may rise because of wages increases not associated with productivity rise.

Rise in profit margin

High import price

Shortage of essential inputs.

often inflation is caused by structural maladjustment and unbalanced growth of the different section of society.

The faster rate of growth of industrial sector and a slow rate of growth of primary sector may lead to increase in food price which may lead to an increase in general price level. This is called structural inflation, which is generally found in less developed countries of the world.

On the basis of origin, inflation may be classified in two type

Demand pull  
Cost push

Inflation may be classified into two ~~rate~~ form  
Open inflation  
Repressed inflation.

On the basis of degree of <sup>price</sup> rise inflation can be classified into three group.

Hyper inflation  $\rightarrow$  <sup>It is also known as</sup> running / galloping / severe inflation  
Rate of increase  $\rightarrow$  10% or more

Creeping inflation  $\rightarrow$  Rate of increase  $\rightarrow$  2 to 4%

~~Running~~ <sup>moderate</sup>

moderate inflation  $\rightarrow$  also known as <sup>walking</sup> ~~running~~ inflation  
Rate of increase  $\rightarrow$  5 to 9%

Inflation may be :-

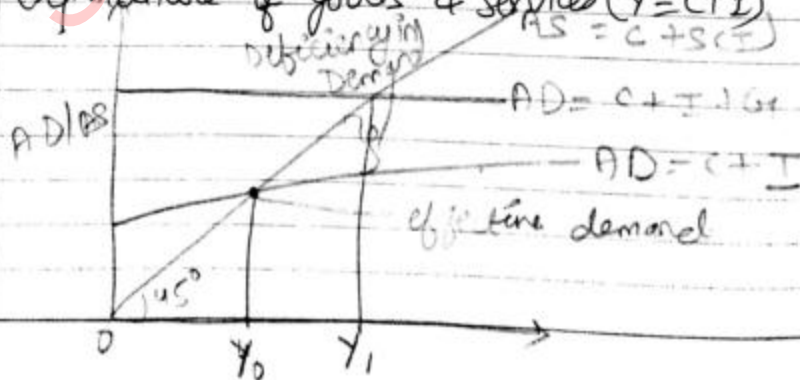
True inflation - True inflation take place after full employment of all factor inputs in an economy.

Semi-Inflation - Semi-Inflation taken place before full employment a country may experience inflation arising from bottlenecks. There may be inflationary price rise in some sectors of the economy.

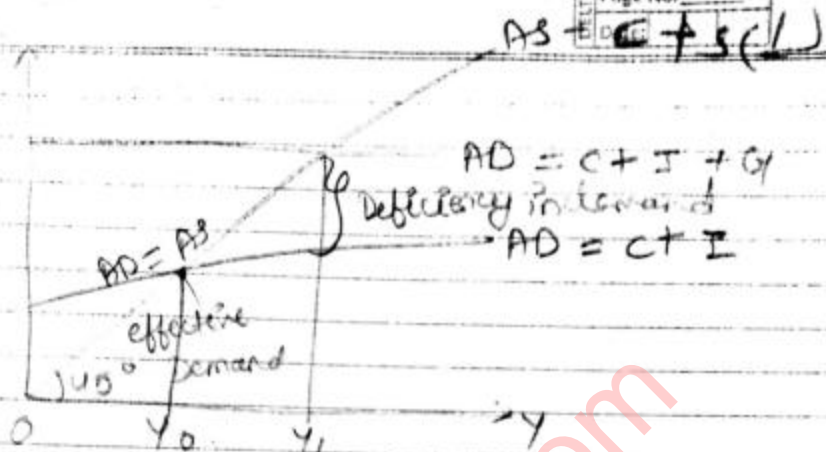
The policies for achieving full employment

The classical economist believed that an economy achieve ~~the~~ full employment automatically. If supply creates its own demand.

As stated as Say, an economy can go on producing till all factors are fully employed, provided wages and prices are flexible. Thus general over production and unemployment were ruled out. A state of full employment was supposed to be inevitable. There may be under employment equilibrium. It is the level of income in total income is equal to total expenditure of goods & services ( $Y = C + I$ )







AS =  $C + S(L)$  curve intersects the  $45^\circ$  curve. That is equilibrium point at that level of income, the economy is under full employment.

If  $C + I$  curve shift upwards and interest explanation?

### Role of Government

A vigorous ~~monetary~~ monetary fiscal mix i.e. a combination of monetary and fiscal policy is essential for lifting an economy from depression and unemployment to full employment.

### Anticyclical monetary policy

It is formulated by central bank. It is known as cheap money policy. Money is said to be cheap when it can be obtained at a <sup>very</sup> low rate of interest. If liquidity preference <sup>remains</sup> unchanged, an increase in money supply will go to reduce interest rate. Naturally



investment expenditure of the private sector will grow. A fall in interest rate will lead to rise in price of bonds, securities etc. This will increase household sector's investment in financial assets too. The Net national product in effect will grow. Increase in money supply may continue till ~~the~~ NNP reaches the full employment level.

### Fiscal Policy

Government's tax and expenditure policy for realising the goal of full employment is compensatory in nature. It seeks to compensate the shortfall in private sector (C+I) which is supposed to be the cause of deviation from full employment. Fiscal policies need to be two edged - taxing less and spending more. Taxing less is same as leaving more in the hands of people so that they ~~can~~ spend more. Expenditure by govt. for public works & welfare activity may raise private effective demand also.

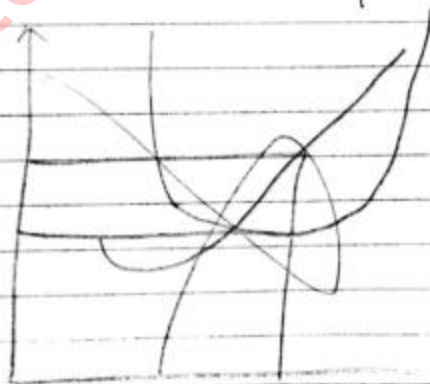
### Limitations

- ① It may retard private investment. Easy & cheap credit may be harmful to the business sector as they will find no incentive to raise resources internally.
- ② More spending by the govt may raise the effective demand of 'few' and the effective demand of many remain unchanged. So the character

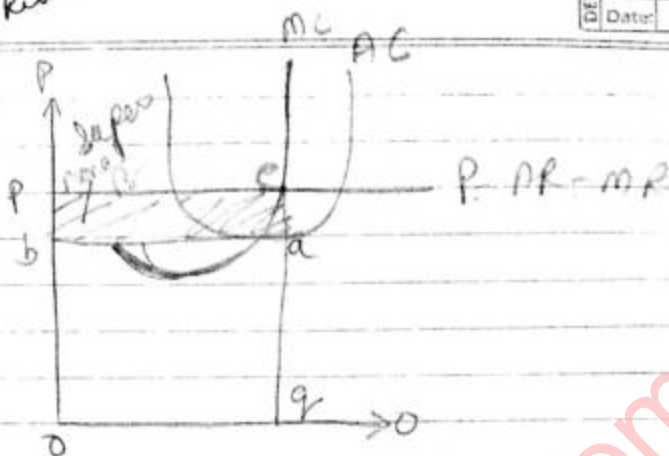
- ③ Of effective demand is important as its level. A vast public expenditure may not achieve full employment of labour for shortage some complementary resource like technical personnel, foreign exchange etc.

### Capital formation

Capital formation means a sustained increase in the stock of real capital in a country. In other words, capital formation involve prodn of more capital goods like machines, tools, factories, transport equipment, electricity etc. which are all used for further prodn of goods. Capital formation is also known as investment. The need for capital formation or investment is realised not merely for replacement and renovation but for creating addition productive capacity. In order to accumulate capital goods, some current consumption is to be sacrificed & savings of current income to be made. Savings are also to be channelised into productive investment.

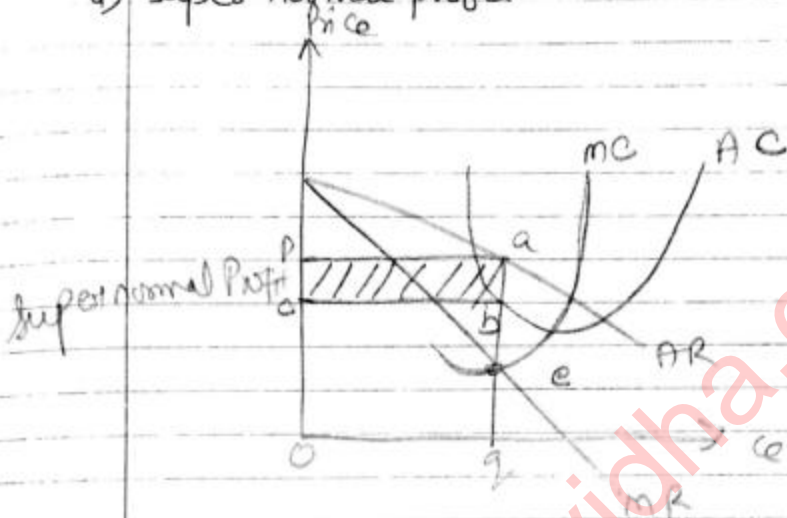


Short Run



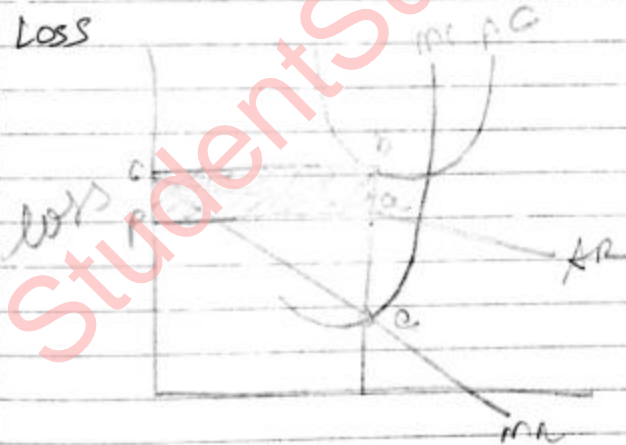
Long Run

a) Super normal profit



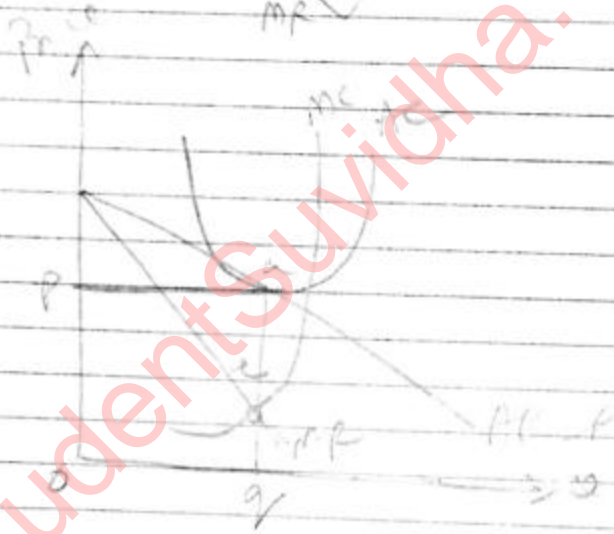
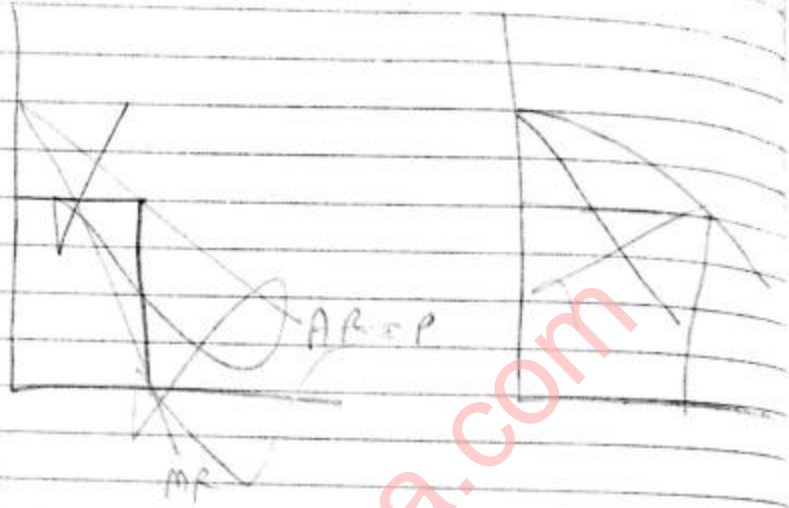
Profit

b) Loss





(iii) No Super normal profit or loss



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## Credit creation by commercial bank

A commercial bank is <sup>called</sup> a dealer of credit. But it is more than that. It can create credit i.e. it can expand the ~~monetary~~ monetary base of the country. It does so not by issuing new money but by its loan operation.

Banks do not create money out of air but on the basis of cash deposit. The process of credit creation is that the depositors think they have so much money with bank and borrowers ~~th~~ from bank say they have so much money with them. Summing the two, we find an amount more than the cash deposit.

Suppose a bank receives of Rs 1000 as deposit keep with it 20% (Rs 200) as CRR and lend and rest. Depositor will claim he has Rs 1000 and bank borrowers too possess Rs 800. Thus total money supply appears to be Rs 1800 only. It is the credit creation of single bank.

The above example can be extended to cover the banking system as whole. Suppose Rs 800 is deposited to another bank. This bank's base will now expand. It will keep 20% of Rs 800 (Rs 160) as Cash Reserve and will lend Rs 640. This sum is deposited to a third bank which keeps 20% of 640 (Rs 128) grants a loan of Rs 512. This process will continue and the amount of fresh deposit will go on falling. At a time will come when deposited sum will be equal to CRR. The process will then come to

an end. ~~The sum of the series can be calculated as follows:~~

$$1000 + 840 + 640 + 512 + \dots + n$$

After this transaction an initial deposit of Rs 1000 with the bank has resulted in the creation of deposits by three banks amounting of Rs 1000 + 800 + 640 + 512 = 2952 and the process of credit creation is still going on. But this is not a never ending process. As it is obvious the amount of credit credited by every successive bank is decreasing continuously. The process will come to end when the deposit received by a particular bank is too small to generate any fresh loan. If you work out the process of credit creation through all its stages, you will find that the entire banking system will be able to create the new deposits to the tune of Rs 5000 on the basis of an initial deposit of Rs 1000.

The amount of credit creation by the banking system as a whole can be worked out by the following formula!

$$\text{New Deposits} = \frac{1}{RR} \times \Delta D$$

where RR is the reserve ratio

$\Delta D$  is the initial change in the volume of deposits

$$\begin{aligned} \text{New Deposits} &= \frac{1}{20\%} \times 1000 \\ &= \frac{1}{20/100} \times 1000 \end{aligned}$$



$$= \frac{100}{20} \times 1000 = \text{Rs } 5000$$

Thus on the basis of an initial deposit of Rs 1000 the banking system as a whole is able to generate bank deposit of Rs 5000. The above formula is known as the RR

deposit multiplier or credit multiplier. The value of the credit multiplier is reciprocal of the required reserve ratio.

### Distinction b/w Central Bank and Commercial Bank

#### Central Bank

1. It is the apex bank in the money market of a country.
2. Its purpose is to make profit for the borrower.
3. The Central bank does not accept deposit money or lend money to general public.
4. The Central bank issue paper notes in fact it enjoys the monopoly power in this matter.

#### Commercial Bank

1. It is merely a unit in banking system structure of the country.
2. The commercial bank is organised to make profit for their owners.
3. This is the most important function of commercial bank. It accepts deposits or lend to public.
4. Commercial bank does not enjoy this power. They create credit.



3. It decides a monetary policy to realise economic stability and full employment in the country.
4. It is the custodian of nation's gold & foreign exchange reserve.
5. It plays a supplementary role. It is quite often regulated by the Central Bank.
6. It does not perform such functions.
7. The Central bank acts as the bankers to the govt.
8. The commercial banks are bankers to private industrial institutions.

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