**BCOM SEM 3**

**Principles Of Macro Economic 1**

**Question Bank With Answers.**

**Q.1 Explain in detail the meaning, features and function of money?**

**Ans:-**

Money is any commodity accepted by general amount as a medium of economic exchange.

It is the medium in which arises & values are expressed as currency it circulates anonymously from person to person and country to country.

Thus, facilitating trade & it is the principle measure of wealth.

Invention of money is the most important fundamental in economics.

Money is at the center of all economic activities.

Entire economic science rotates around money.

**According to Walker “Money is what money does.”**

**According to Seligman “Money is the one thing that possess general acceptability.”**

**According to Crowther “Money can be defined as anything that is generally accepted as a means of exchange and at a same time acts as a measure and as a store of value.”**

**Functions Of Money**

The functions of money are the same which were defects in barter system. More formally money in classical economics is defined by the following functions:-

1. **Medium of exchange**

* Money acts as a medium of exchange which can be used for buying & selling of goods & services.
* This transfer of money from buyer to seller allows the transaction to take place.
* It plays a mediator role between purchase & sales.
* It replaced barter system with money exchange system.

1. **A unit of account**

* Money is the common standard for measuring relative worth of goods and services.
* Money is used to designate the prices of goods and services.
* Any item that is generally accepted as payment for goods and services is also the obvious choice for denominating the prices of those goods and services.

1. **A storage of value**

* Money’s value can be retained over time & a convenient way to store wealth.
* Money can be used to transfer purchasing power from present into the future.

1. **A standard of deferred payment**

* Money is used to designate future payment such as those for loan repayments.
* The standard of deferred payments is a natural result of the standard unit of account & store of value function of money.

**Features**

1. **Durability**

* It means that the item must be able to exist for a long time without deterioration and to with stand being used repeatedly.
* Durability is critical for money to perform the related function of medium of exchange and stale of value.
* Items that are considered currency coins and paper bills used as money meet this requirement.
* In modern days money is made out of paper metal and plastic which make money long lasting.

1. **Portability**

* Portability means that individuals are able to carry money with them and transfer it easily to other individuals.
* This is why coins and paper money have historically proved popular.
* In modern days, money is carried from one place to another with less effort where a wallet can carry any type of money including notes, coins & debit cards.

1. **Divisibility**

* Divisibility means that the money can easily be divided into smaller units of value.
* When people used stones and tobacco as money, they not able to divide those into small pieces in a standard form where they used it as a whole or divided into small pieces but it was lacking standardization.
* In modern days, people have notes and coins from low values to high notes and coins from low values to high values where they are used to divide money into small units of account.

1. **Uniformity**

Uniformity means that all versions of the same denomination of currency must have the purchasing power.

1. **Limited supply**

* Limited supply means the restrictions on the amount of money in circulation power so that values remains relatively instant for the currency.
* Currently, respective country’s government has the responsibility to control or maintain an adequate money supply to the market based on their mandatory policies.

1. **Acceptability**

* Means that everyone must be able to use the money for transactions.
* Money is universally accepted anywhere in the world as a universal means for transactions.

**Q 2 Evaluate in detail the components of money supply and the determinants of money supply?**

**Ans:**

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* Supply of money plays an important role in modern economics.
* In a narrow sense, supply of money is the total stock of money held by the public at a given point of time.
* The stock of money includes that components of money which fulfill the medium of exchange function of money.
* It includes two components.

1. **Currency with the public.**
2. **Demand deposits held by commercial banks.**

* Broadly money supply includes the total stock of currency, demand deposits held by individuals, private firms over a period of time.

**Constituents or components of money supply**

From April 1977, the RBI has adopted four concepts of money supply in its analysis of the quantum of and variations in money supply.

These four concepts of measures of money supply are explained below:-

1. **Money supply (M1)**

This is the narrow measure of money supply as defined above and us composed of the following items:-

M1 = C + DD + OD

Where:-

C = currency with the public

DD = demand deposit of bank

OD = other deposits of the RBI.

1. **M2**

In addition to the three items of M1 the concept of money supply M2 includes savings deposits with the post office saving banks.

M2 = M1 + savings deposits with post office

1. **M3**

This is also called broad money.

Besides the items of M1, the net time deposits of the banks are also included in M2 in the terminology of money supply employed by the RBI till April 1977.

Thus M3 was called aggregate monetary resources thus.

M3 = M1 + net time deposits with the banks.

1. **M4**

The measure M4 of money supply includes not only all the times of M3 described above but also the total deposit with the post office saving organizations.

However, this excludes contribution made by the public to the national saving certificates thus,

**RBI’s new measure of money supply**

RBI’s working group has introduced new measures of money supply since 1998.

These are three measures of money supply

M1, M2, M3

M1 = C + DD + OD

M2 = M1 + time liability portion and savings deposits with banks + certificate of deposits issued

by banks + term deposits maturing within one year.

M3 = M2 + term deposits over one year maturity + call or term borrowings of banks.

**Determinants of money supply**

The monetary authority while determining the supply of currency and the coins must be guided by the general requirements of the economy.

The currency components of the money supply i.e. coins and notes is influenced by a number of factors as follows:-

1. **Volume of transactions**

* The supply of currency must very in accordance with the changes in physical volume of trade and transactions of the economy.
* If the issue of the currency is more than what is required.
* It creates inflationary pressures.
* On the other hand, if the money supply is less than the requirements it leads to deflationary trends.

1. **Nature of trade**

* The nature of trade, whether wholesale or retails, determines the proportion of currency of different denominations.
* For wholesales trade the notes of higher denominations are required where the retail trade requires larger proportion of notes & coins of lower denominations.

1. **Methods of payments**

* The methods of payment being used in the economy also determines the currency components of the money supply.
* If most of the payment are made in cash in greater proportion of currency money supply is needed.
* If payments are generally made through cheques, the proportion of currency to money supply will be lowered.

1. **Price level**

* Price level also affects the requirements of currency considerably.
* Higher the price level larger the amount of currency required and lower the price level smaller the amount of currency required to carry out the given volume of transactions.

1. **Banking habits**

* If the public has confidence in the bank money and has banking habits the currency requirements will be less.
* But if the people have less banking habits the transaction will be conducted with currency and more currency is required.

1. **Cash reserve ratio.**

* The cash reserve ration determined by the central bank is as important determinant of the money supply.
* The smaller the value of case reserve ratio, greater is the credit creating capacity of banks and hence more money supply in the economy.

1. **Velocity of circulation of money.**

* Higher the velocity of circulation of money, higher is the money supply and vice versa.

1. **Fiscal policy.**

* Government expenditure increases the money supply in the economy.
* When the government expenditure increases, government resorts to public borrowing or deficit financing.
* Deficit financing means creation of money.
* This increase the money supply in the economy.

1. **Liquidity preference**

* People’s desire to hold liquid cash also determines the money supply in the economy.
* If people prefer to hold more cash with themselves it will reduce the volume of cash with the banks.

1. **Monetary policy**

* Monetary policy of the central bank is an important determinant of the money supply.
* If the central bank adopts in expansionary monetary policy it will be increase in the money supply in the economy.
* On the other hand if the central bank adopts a contraction monetary policy it will reduce the money supply.

**Q 3. Evaluate in detail the concept of velocity of circulation of money?**

**Ans:-**

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The velocity of circulation of money determines the law of money supply in an economhy in a given period of time, normally such period is one year.

The velocity of circulation of money is the average number of times a unit of money changes hands.

The supply of money in a given period is obtained by multiplying the money in circulation with the amount of money in circulation with the efficient of velocity of circulation.

**\* The following are the factors determining the velocity of circulation of money**

**(1). Money supply :**

Velocity of money depends upon the supply of money in the economy in the supply of money in the economy

If supply of money in the economy is less then its requirements then the velocity of money will increase & if the money supply is less then its requirement the velocity of money will fall.

**(2). Value of money :**

The velocity of money is high during inflation when value of money decreases because people will like to part with money as soon as possible.

Similarly, during deflation when the value of money rises the velocity of money is low because people like to keep money with then.

**(3). Credit facilities :**

The velocity of money increases with the expansion of lending and borrowing facilities in the country.

Therefore, the growth of credit institutions has a favorable effect on the velocity of money.

**(4). Volume of trade :**

As the volume of trade increases the number of transaction and the velocity of money increases & as the volume of trade decreases the velocity of money decreases.

**(5). Frequency of transaction :**

With the increase in the frequency of transactions, the number of payments and receipts increases and as a result velocity of money increases.

Similarly with the decrease in the frequency of transactions, the velocity of money decreases.

**(6). Business conditions :**

The velocity of money increases during the period of hectic business conditions and decreases during slump conditions.

**(7). Business integration :**

If business is vertically integrated the velocity of money will be loss if business is vertically disintegrated the velocity of money will increase.

**(8). Payment system :**

The velocity of money is also determined by the frequency with which the labor force is paid and the speed with which the bills for goods are settled.

**(9). Regularity of income :**

If people receive income at regular intervals they will spend their income more freely and the velocity of money will increase.

But if people receive their income at irregular intervals.

They will prefer to hold more cash balances to meet the uncertain conditions in future and the velocity of money will fall.

**(10). Propensity to consume :**

Greater the tendency of the people to consume other things remaining the same, higher will be the velocity of money.

On the contrary lower the propensity to consume lesser will be the velocity of money. On the contrary lower the propensity to consume lesser will be the velocity of money.

Saving or not consuming has an adverse effect on the velocity of money.

**Q 4 Evaluate in detail the quantity theory of money?**

**Ans. :-**

* The quantity theory of money states that there is a direct relationship between the quantity of money in an economy and the level of prices of goods and services sold qtm can be studied with the help of the following approaches,

**(1). Transaction approach to demand for money or Fishers approach**

* + American economist Irving Fisher gave the transaction approach to demand for money in his book purchasing power of money 1911.
  + The transaction approach is part of the classical monetary theory approach.
  + According to the classical economist money is demanded for its function as a medium of exchange.
  + People demand money to enable then to undertake transactions of goods & services.
  + Any transactions involves exchange of goods & services against money.
  + In accounting identity the Value of goods and services must be equal to the value of money paid.
  + The total value of transactions is obtained by multiplying the number of transaction(T) by the average price level(P).
  + Thus value of money paid is equal to quantity of money supply(M).
  + Multiplied by the velocity of circulation of money(V).
  + Thus the value of money then is MV.
  + The Fisher equation of exchange can be,

**MV = PT**

**M = PT**

**V**

When, M = the quantity of money in circulation.

V = velocity of circulation of money.

P = average price level.

T = total number of transaction.

* Money must equilibrium is given at that point where demand for money is equal to the supply of money.

**MD = MS**

We can rewrite eq2 as,

**MD = PT**

**V**

The demand for money is determined by,

(1). The number of transaction(t).

(2). The average price level(P)

(3). The velocity of circulation of money(M).

**(2). The cash balance approach or the Cambridge approach of demand for money.**

The cash approach is associated with Cambridge economist like Alfred Marshall, Pigou, Robertson and Keynes.

The cash balance approach emphasized the demand side of money.

According to this approach the demand for money demands on two functions of money,

🡪Its utility as a medium of exchange.

🡪Its utility as a store of value.

According to the Cambridge economists demand for money arises from the peoples desire to hold money or goods and services.

The demand for money functions is expressed as

**MD = kpy**

When, MD = the demand for money.

K = proportion of the nominal income that people want to hold as cash balances.

PY = nominal income.

The demand for money is a proportional function of nominal income higher the nominal income, higher the demand for money.

**Q 6:- Explain in detail the meaning and various types of money?**

**Ans.**

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**There may be various types of money**

**(1). On the basic of acceptability :-**

Money can be furthered classified into two broad category,

**(1). Legal tender money**

Money which is supported by law is called legal lender money.

Nobody can refuse to accept the payments in forms of money because it is

supported by law.

They may be two types of LTM,

**(a). Unlimited LTM**

Money which is a legal tender to an unlimited extent is known as unlimited LTM.

In this case payments can be made to any extent by using this money.

e.g., notes of rupees two onwards issued by RBI is unlimited LTM.

**(b). Limited LTM.**

Money which is a legal tender but only upon limited extent is known as limited

Tender money.

Beyond a certain limit it become non legal tender money.

e.g., all small coins upon rupee one are legal tender only to the extent of Rs. 25.

**(2). Non legal tender money**

It refer to money which is not a legal tender it is not supported by law.

A person can accept the payment or he can refuse to accept the payments in forms of optional money.

They are accepted because of custom.

Bank cheques, bills of exchange are now legal tender money.

**(2). On the basic of monetary system**

Money can be classified into the following bread categories :-

**(1). Metallic money :-**

It refers to the metals of which money is composed of they made be following types of metallic money.

**(a). Full bodied coins :**

It refers to metal coins made up of metals like gold or silver.

In case of such coins face value of the coin is equal to intrinsic value.

Face value refers to the exchange value of the coin.

Intrinsic value refers to the value of the metal content in the coin.

**(b). Token coins :**

They refer to coins made up of cheaper metals like nickel.

In case of token coins face value of coin is greater than the intrinsic value.

**(2). Paper money :-**

It refers to money which is made up of paper.

Currency note issued by government &the central bank.

There may be three types of paper money.

**(a). Represented paper money :**

It refers to the paper money which is 100% supported by gold reserved. Thus, government will create paper money equal to the value of gold reserved it has got.

**(b). Convertible paper money :**

It refers to the paper money which can be convertible into gold from money

creating authority.

Thus, the authority who has issued paper money has promised to convert the

paper notes into the gold.

**(c). Inconvertible paper money :**

It is also known as fiat money. i.e., money by the command of the sovereign.

Thus, money cannot be converted into gold from the money authority but it is

accepted because it is accepted.

**(3). Plastic money :**

Refers to credit cards issued by banks the card holder can make purchase by

paying through credit card.

The account of lower is settled by card issuing bank at regular intervals.

When card holder delays the payment a higher interest is charged by the bank.

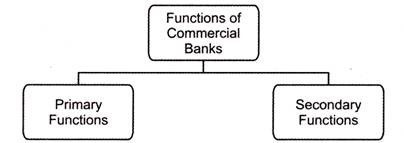
**Q .7 Evaluate in detail the meaning and functions of commercial banks?**

**Ans:**

* In modern economy, commercial banks play an important role in the financial sector.
* A bank is an institution dealing in money & credit.
* Credit money is the major component of money supply in a modern economy.
* Commercial banks are the creators of credit.
* The strength of economy of any country basically depends on a sound & solvent banking system.
* A commercial bank is a profit seeking business firm dealing in money or rather claims to money.
* It safeguards the savings of the public and give loans & advances.
* The banking companies act of 1949 defines banking company as “ Accepting for the purpose of lending or investment of deposit money from the public repayable on demand or otherwise and withdrawable by cheque,drafts, order or otherwise.”

**Functions Of Commercial Banks.**

A Commercial bank performs banking primary functions & non banking or secondary functions to meet the growing requirements of trade, commerce and industry.



**Primary Functions.**

Commercial banks performs various types of banking functions. They are as follows:



1. **Accepting Deposits:**

One of the main functions of a bank to accept deposits from the public. Deposits are accepted by the banks in various forms.

1. **Current Account Deposits:**

* Current accounts are usually opened by businessmen who have a number of regular transactions with the bank, both deposits and withdrawals.
* There is no restrictions on number and amount of deposits.
* There is also no restrictions on withdrawals.
* No interest is paid on current deposits.
* Banks may even charge interest for providing this facility.
* These accounts are also known as demand deposits as amount can be withdrawn on demand.

1. **Savings Account Deposits:**

* Saving accounts are opened by salaried and other less income people.
* There is no restriction on number and amount of deposits.
* Withdrawals are subject to certain restrictions.
* It earns interest but less than fixed deposits.
* It encourages savings habit among salary earners and others.
* Savings deposits are an important source of funds for banks.

1. **Fixed Account Deposits:**

* Deposits in fixed account are time deposits.
* Money under this account is deposited for a certain fixed period of time varying from 15 days to several years.
* A high rate of interest is paid.
* If money is withdrawn before expiry date, the depositor receives lower rate of interest.
* Deposits can be renewed for further period.
* Many banks sanction loans against security of fixed deposits

1. **Recurring Account Deposits:**

* In recurring deposit a specified amount is regularly deposited by account holder at an interval of usually a month.
* This is to form the habit of small savings among the people.
* At the end of maturity period the account holder gets substantial amount.
* Interest on this type of deposit is almost equal to fixed deposits.
* Thus by creating variety of deposits banks motivate people in a variety of ways and encourage savings in the economy.

1. **Lending Money:**

* Banks not only mobilize money but also lend to its credit worthy customers for maximizing profits.
* Generally banks advance loans for the following:

1. **Cash Credit:**

* Banks provide loans for a given period on the security of shares, debentures and movable and immovable properties.
* This is the most common methods of advancing loans.

1. **Loans & Advances:**

* Under it banks provide loans & advances to its customers on adequate security.
* Such amount of loans and advances are deposited in the account of the borrower & withdraw the amount as & when he requires.
* Such facility is given for a certain period.

1. **Overdraft:**

* Overdraft facility is provided under the current account.
* The current account holder can withdraw more than the deposit in the account.
* The overdraft facility depends on the credit of the customers.
* Such facility is given for short term and emergency purposes.

1. **Discounting Of Bills Of Exchange:**

* Under this method banks provide credit against eligible commercial bills.
* Seller writes such bills & buyer accepts it.
* The buyer promises to pay given amount for given period.
* Such bills are discounted by banks & payment is made to the customer.

**Secondary Function.**

1. **Agency Functions:**

* Banks acts as agents of their customers and render services.
* The following are the agency functions of the banks:

1. **Collection of payments of cheques bills of exchange & other letter of credit:**

* Banks collects payments of cheques,bills of exchange & other letter of credit deposited by the customers in the bank.
* Banks acts as an agent on behalf of the customer & collects deposits.

1. **Receiving Payments for customers:**

* Banks also receive rent, interest, dividend etc on behalf of their customer.

1. **Payments on behalf of customers:**

* Banks not only receive payments on behalf of their customers but also make payments on behalf of customers in the form of rent, interest, dividends, commission, etc.

1. **Transfer of money:**

* Banks transfer money from one place to another as directed by their customers.
* Bank draft, postel & telegraphic transfer are the methods through which such transfers take place.

1. **Purchase & sale of shares & securities:**

* Banks purchases & sales shares, securities on behalf of their customers.

1. **Functions of manager, trustee & executer:**

* On the direction of customer, bank performs the function of manager, trustee & invester.

1. **Underwriting functions:**

* Large industrial houses raise capital from market.
* Banks helps companies to raise money by acting as an under writer.

1. **General Utility Functions:**

* Besides agency functions, banks also perform other services like:

1. **Locker Facility:**

* Banks provide locker facility which enables customers to keep valuables like gold, shares, important documents with the banks etc.

1. **Financial Adviser:**

* Banks advise their customers on economic & financial matters.

1. **Referee:**

* A commercial bank acts as a referee to the financial standing of his customers.
* This is a very valuable service to businessmen as it enables them to obtain goods & services on credit.

**Q 7. Explain in detail the process of credit creation?**

**Ans:**

* In modern economy, commercial banks play an important role in the financial sector.
* A bank is an institution dealing in money & credit.
* Credit money is the major component of money supply in a modern economy.
* Commercial banks are the creators of credit.
* The strength of economy of any country basically depends on a sound & solvent banking system.
* Banks occupy a special position in the monetary system because of their ability to create credit.
* According to Sayer “ Banks are not merely purveyors of money, but also in an important sense, manufactures of money.”
* The credit creation is done by the entire banking system.
* Therefore it is called as multiple credit creation.

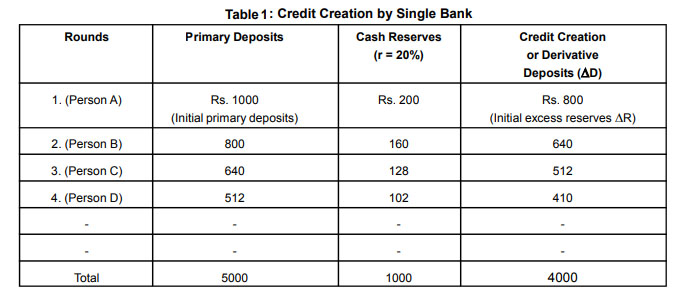
**Process Of Credit Creation.**

* In modern economy a large proportion of total supply of money consists of bank demand deposits.
* When customer of the bank deposit cash with the bank it create demand deposit in the name of the customer.
* Such deposits are known as primary deposits.
* The banks knows from experience that the money kept in primary deposit are not withdrawn at one go.
* The money is withdrawn in installments.
* The banks knows that it requires a certain volume of cash reserves to meet these commitments.
* The remaining amount is used by the banks the create credit.
* When a bank grants a loan to customer it does not make payments in cash.
* Instead the bank opens an account in the name of the customer.
* Such deposits are known as derivative deposits & arise from granting of loan by the bank.
* The customer is authorized to withdraw money from his account by issuing cheques as & when required.
* It is because of this system that we have the banking maxim “ Every Loan Creates Deposits.”
* Now the customer with derivative deposits may issue cheques out of this deposit to make payments arising out of business transactions.
* The payees in this transaction may deposit these cheques with another bank.
* Now this another bank accepts these of which it will create derivate deposits.
* In this way the total volume of credit created by all the banks are a multiple of the initial amount created by the initial bank.

There are two ways of analyzing the credit creation process:

1. Credit creation by a single bank
2. Credit creation by the banking system as a whole

In a single bank system, one bank operates all the cash deposits and cheques. The process of creating credit is explained with the hypothetical example below:



Let’s assume that the bank requires to maintain a CRR of 20 percent.

* If a person (person A) deposits 1,000 rupees with the bank, then the bank keeps only 200 rupees in the cash reserve and lends the remaining 800 to another person (person B). They open a credit account in the borrower’s name for the same.
* Similarly, the bank keeps 20 percent of Rs. 800 (i.e. Rs. 160) and advances the remaining Rs. 640 to person C.
* Further, the bank keeps 20 percent of Rs. 640 (i.e. Rs. 128) and advances the remaining Rs. 512 to person D.

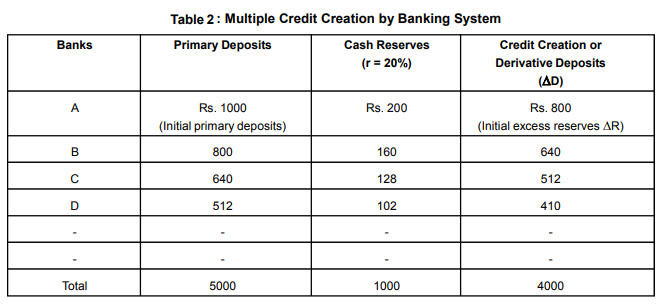
This process continues until the initial primary deposit of Rs. 1,000 and the initial additional reserves of Rs. 800 lead to additional or derivative deposits of Rs. 4,000 (800+640+512+….).

Adding the initial deposits, we get total deposits of Rs. 5,000. In this case, the credit multiplier is 5 (reciprocal of the CRR) and the credit creation is five times the initial excess reserves of Rs. 800.

### Multiple Credit Creation by the Banking System

The [banking](https://www.toppr.com/guides/general-awareness/banking/types-of-banking/) system has many banks in it and it cannot grant loans in excess of the cash it creates. When a bank creates a derivative deposit, it loses cash to other banks.

The loss of deposit of one bank is the gain of deposit for some other bank. This transfer of cash within the banking system creates primary deposits and increases the possibility for further creation of derivative deposits. Here is an illustration to explain this process better:



As explained above, the initial deposit of Rs. 1,000 with bank A leads to a creation of total deposits of Rs. 5,000.

**Assumption.**

* All the money should remain with the banking system & there is no leakage from the banking system.
* The commercial banks should stick on to a stipulated cash reserve ratio.
* The banks must receive new deposits.
* They must be willing to make loans or buy securities.
* People must be willing to borrow.
* People must choose to leave their money on deposit with the banks so that the derivate demand deposits become primary deposits.
* There should be popular banking habit in the country.
* There is no credit control policy of the central bank.
* Business conditions are normal.

**Q 8. Evaluate in detail the functions of RBI or a Central Bank?**

**Ans:**

* In modern economy, commercial banks play an important role in the financial sector.
* A bank is an institution dealing in money & credit.
* Credit money is the major component of money supply in a modern economy.
* Commercial banks are the creators of credit.
* The strength of economy of any country basically depends on a sound & solvent banking system.
* A Central Bank is the highest financial institution in the country.
* It is the leader of the banking system and highest monetary authority of the country.
* Central Bank Of India is RBI it was set up on 1st April 1935 as private share holders bank.
* It was nationalized on 1st Jan 1949. Since then RBI is performing various functions of a Central Bank in India.
* Various functions that are performed by a Central Bank in any part of the world are explained below.

**Functions Of RBI Or Central Bank.**

1. **Bank Of Issue:**

* A Central Bank is the bank of issue in the country.
* It enjoys monopoly of note issue.
* In India RBI has monopoly power to issue currency.
* When this power is given only to Central Bank there will be two advantages:
* There will be homogeneity in note issue.
* There will be elasticity in amount of money.

1. **Banker To The Government:**

* A Central Bank is banker to government .
* As a banker to government a central bank keeps deposits of different government bodies and transfer money from one account to other account as per the instructions of the government.
* A central bank is also advisor & agent to government.
* As advisor to governments it provides important advices to government with regards to formation of economic policies.
* As agent to government central bank buys or sell government securities in the market.

1. **Banker to the banks:**

A Central Bank is the banker to the bank in the country. As a banker to the banks central bank performs the following functions:

* It accepts deposits of money from various banks of the country. All banks in the country are suppose to keep deposits with the central bank.
* A Central Bank acts as a centre of clearing house. Inter bank indebtedness is settled through the central bank.
* A Central Bank is the lender of last resort to the banks in need.

1. **Controller of credit:**

* A Central Bank acts as a controller credit created by commercial banks.
* Central bank may use various types of quantitative & qualitative methods to control the credit created by commercial banks.

1. **Custodian of foreign exchange reserves:**

* A Central Bank is the custodian of foreign exchange reserves.
* All foreign currency earned by a country is under the custody of central bank of the country.
* .This is important to ensure that there will not be any misuse of foreign exchange.
* Any individual or organization will have to take the permission of central bank for the use of foreign exchange.

1. **Collection & publication of data:**

* A Central Bank collect data related to various issues in the economy.
* Such information’s are published by the Central Bank in journal, bulletin’s etc.
* They may be of great importance for the scholars of economics & government of the country.
* A Central Bank can also appoint committee of experts to find out causes & solution of any economic problem that country is facing thus could be accepted by the government.

1. **Promotional functions:**

* A Central Bank is responsible to promote economic development of the country.
* It has to create a suitable atmosphere for economic development of the country.
* Central Bank must develop a sound banking system & proper money market so that loans will be available for development activities.
* It will encourage economic development of the economy.

**Q 9 Evaluate in detail the instruments or measures of a Central Bank or RBI to control credit?**

**Ans:**

The Central Bank undertakes credit control to achieve the following objectives:

* To promote internal price stability & control trade cycles.
* To maintain exchange rate stability & smooth international trade.
* To stabilize the money market.
* To attain high level of production, income, and full employment.
* To promote economic growth with stability.

The Central Bank Uses two types of tools for controlling the volume of credit

1. **Quantitative Methods:**

* These methods are used for regulating the flow of credit to all the sectors of the economy.
* They are directed towards increasing the total volume of credit from the commercial banks to the economic system as a whole, irrespective of the purpose for which credit is used by the borrowers.
* They are used to stabilize the general price level. The following are the quantitative methods/ instruments to control credit.

**Bank Rate.**

* One of the most effective instruments of monetary policy is the bank rate.
* A bank rate is essentially the rate at which the RBI lends money to commercial banks without any security or collateral.
* It is also the standard rate at which the RBI will buy or discount [bills of exchange](https://www.toppr.com/guides/accountancy/bill-of-exchange/) and other such commercial instruments.
* So now if the RBI were to increase the bank rate, the commercial banks would also have to increase their lending rates.
* This will help control the supply of [money](https://www.toppr.com/guides/general-awareness/money-and-money-market/introduction-to-money/) in the market.
* And the reverse will obviously increase the supply of money in the [market](https://www.toppr.com/guides/business-economics/meaning-and-types-of-markets/market-meaning-and-classification/).

**Open Market Operations**

* Open Market Operations is when the RBI involves itself directly and buys or sells short-term securities in the open market.
* This is a direct and effective way to increase or decrease the supply of money in the market.
* It also has a direct effect on the ongoing rate of interest in the market.
* Let us say the [market is in equilibrium](https://www.toppr.com/guides/economics/market-equilibrium/) then the RBI decides to sell short-term securities in the market.
* The supply of money in the market will reduce.
* And subsequently, the demand for credit facilities would increase.
* And so correspondingly the rate of interest would also see a boost.

**CRR**

* Cash Reserves Ratio (CRR) refers to the proportion of total deposits of the commercial banks which they must have keep as cash reserves with the central bank in the form of cash.
* Cash reserve ratio is determined by central bank so that it can be used as a quantitative instrument to control the amount of credit creation by the commercial banks at the time of inflation or deflation in the economy.
* During inflation, cash reserve ratio is increased to reduce the total money supply in the economy by reducing the amount of credit creation by the commercial banks and during deflation, cash reserve ratio is decreased to increase the total money supply in the economy by increasing the amount of credit creation by the commercial banks.

**SLR**

* Statutory Liquidity Ratio or SLR is the minimum percentage of deposits that a commercial bank has to maintain in the form of liquid cash, gold or other securities.
* It is basically the reserve requirement that banks are expected to keep before offering credit to customers.
* The SLR is fixed by the RBI and is a form of control over the credit growth in India
* The government uses the SLR to regulate inflation and fuel growth.
* Increasing the SLR will control inflation in the economy while decreasing the statutory liquidity rate will cause growth in the economy.
* The SLR was prescribed by Section 24 (2A) of Banking Regulation Act, 1949.

**Repo and Reverse Repo Rate**

**Repo Rate:**

* The term ‘Repo’ stands for ‘Repurchase agreement’.
* Repo is a form of short-term, collateral-backed borrowing instrument and the interest rate charged for such borrowings is termed as repo rate.
* In India, repo rate is the rate at which Reserve Bank of India lends money to commercial banks in India if they face a scarcity of funds.
* Commercial banks sell government securities and bonds to Reserve Bank of India with an agreement to repurchase the securities and bonds from Reserve Bank of India on a future date at a pre-determined price including interest charges.
* Current [Repo Rate](https://www.paisabazaar.com/rbi/repo-rate/) as of February 2020 is 5.15%.

**Reverse Repo Rate:**

* Reverse repo as the name suggests is an opposite contract to the Repo Rate.
* Reverse Repo rate is the rate at which the Reserve Bank of India borrows funds from the commercial banks in the country.
* In other words, it is the rate at which commercial banks in India park their excess money with Reserve Bank of India usually for a short-term.
* Current [Reverse Repo Rate](https://www.paisabazaar.com/rbi/reverse-repo-rate/) as of February 2020 is 4.90%.

## ****Importance of Repo Rate and Reverse Repo Rate****

* Repo and reverse repo are the monetary measures used by the Reserve Bank of India to deal with the deficiency of funds and liquidity in the market.
* It is a vital money flow control mechanisms used by the central bank.
* Bank lending rates are impacted by repo rate and reverse repo rate.
* Repo and reverse repo are the most effective and efficient tools used by the Reserve Bank of India to achieve price stability and to boost economic development.
* Repo and reverse repo agreements help banks manage their liquidity requirements easily and with a high degree of safety.

1. **Qualitative Methods:**

* Under qualitative methods credit is provided to selected borrowers for selected purpose depending upon the use to which the control tries to regulate the quantity of credit the direction towards the credit flows.
* The following are the qualitative methods/ instruments to control credit.

**Ceiling On Credit.**

* The ceiling on level of credit restricts the lending capacity of a bank to grant advances against certain controlled securities

**Margin Requirements.**

* A loan is sanctioned against Collateral Security.
* Margin means that proportion of the value of security against loans which loan is not given.
* Margin against a particular security is reduced or increased in order to encourage or to discourage the flow of credit to a particular sector.
* It varies from 20% to 80%.
* For agricultural commodities it is as high as 75%.
* Higher the margin lesser will be the loan sanctioned

**Discriminatory Interest Rate. (DIR)**

* Through DIR RBI makes credit flow to certain priority or weaker sectors by charging concessional rates of interest.
* RBI issues supplementary instructions regarding granting of additional credit against sensitive commodities, issue of guarantees, making advances etc.

**Directives.**

* The RBI issues directives to banks regarding advances.
* Directives are regarding the purpose for which loans may or may not be given.

**Direct Actions.**

* It is too severe and is therefore rarely followed.
* It may involve refusal by RBI to rediscount bills or cancellation of license, if the bank has failed to comply with the directives of RBI.

**Moral Suasion.**

* Under Moral Suasion, RBI issues periodical letters to bank to exercise control over credit in general or advances against particular commodities.
* Periodic discussion are held with authorities of Commercial banks in this respect.

**Q 10 Evaluate in detail the concept of aggregate demand & aggregate supply and its components?**  
**Ans:**

* Aggregate demand refers to the total demand for final goods and services in an economy during an accounting year.
* Aggregate demand is aggregate expenditure on ex-ante (planned) consumption and ex-ante (planned) investment that all sectors of the economy are willing to incur at each income level.
* In terms of Keynes, aggregate demand refers to the total amount of money, which the buyers are ready to spend on purchase of goods and services, produced in an economy during a given period.
* It should be kept in mind that Keynes measured aggregate demand not in terms of physical goods and services but as a part of total income that society is ready to spend.  
  **Components of aggregate demand:**

The components of aggregate demand are:

**Private (or Household) consumption demand** (C):

• The total expenditure incurred by all the households of the country on their personal consumption is known as private consumption expenditure.  
• Consumption demand depends mainly on disposable income and propensity to consume.

**Private investment demand (I)**

• Private investment demand refers to the demand for capital goods by private investors.  
• It is addition to the existing stock of real capital assets such as machines, tools, factory – building etc.  
• Investments demand depends upon marginal efficiency of capital (Marginal efficiency of investment) and interest rate.  
• Investment is of two types, Autonomous Investment and Induced investment, but in Keynes theory investment is assumed to be Autonomous.

**Government demand (G)**

* Government demand for goods and services Its curve is upward sloping rises up to Right.
* In a modern economy, the government is an important buyer of goods and services.
* It is income inelastic, i.e., it is not affected by change in income level.
* The volume of autonomous investment is the same at all levels of income.
* Its curve is a straight line parallel to horizontal axis.
* The government demand may be on account of public needs for roads, schools, hospitals, power, irrigation etc, for the maintenance of law and order and for defense.

**Demand for net export (X – M)**

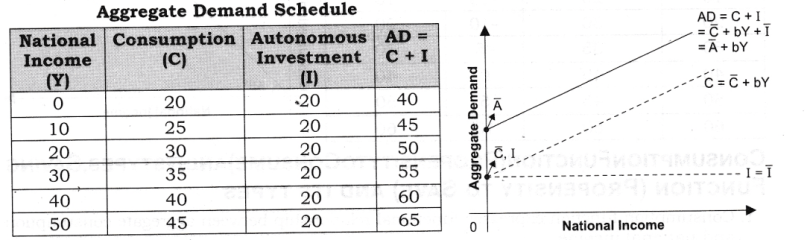
* Net export represents foreign demand for goods and services produced by an economy
* When exports exceed imports, net exports is positive and when imports exceed, net exports is negative.
* Exports and imports of a country are influenced by a number of factors such as foreign trade policy, exchange- rate, prices and quality of goods etc.  
  Thus, aggregate demand consists of these four types of demand.

https://i1.wp.com/cbselearner.com/wp-content/uploads/2019/08/5.3.png?resize=396%2C45

However, for the sake of simplicity Keynes included only two types of demand,  
-> Consumption demand (C)  
-> Investment demand (I)

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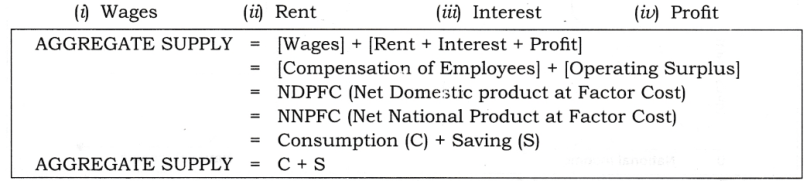
Aggregate demand can be explained with the help of AD schedule and AD curve.



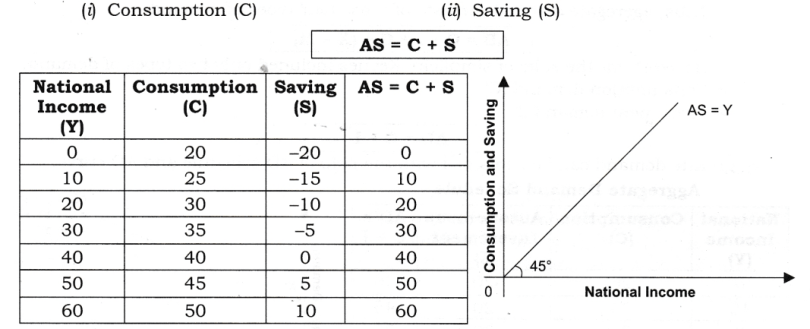
**Aggregate Supply**

The concept of aggregate supply (ΔS) is related with the total supply of goods and services by all the producers in an economy.

* Four factor of production like land,labour, capital and enterprise are required for the production of goods and services.
* Producers pay rent to land, wages and salaries to labour, interest to capital and Profits to the entrepreneur for their services in production.
* This payment is factor- cost from producer’s point of view and factor-income from factor-owner angle.
* Thus, aggregate supply is the total amount of money value of goods and services, (which is paid to the factor of production against their factor services) that all the producers are willing to supply in an economy.
* In other words, it is the total cost of production of goods and services produced in a country or it is the value of net national product at factor cost (NNPFC). Thus, the main components of aggregate supply are:



* Keynes assumed his economy to be a closed capitalist economy and whenever any economy is closed capitalist, then Net Factor Income from Abroad (NFIA) is 0. National Income (NNPFC) = Domestic Income (NDPFC) + Net Factor Income from Abroad (NFIA)  
  National Income (NNPFC) = Domestic Income (NDPFC) + 0  
  In short,  
  Aggregate Supply = NNPFC = NDPFC = Factor Income = Rent + Interest + Wages + Profit.
* As we know income is either consumed or saved, hence for the sake of simplicity Keynes has regarded only two main constituents of aggregate supply:



**Q 11 Evaluate the concept of effective demand?**

**Ans:**

* Keynes’ theory of employment is based on the princi­ple of effective demand.
* In other words, level of employment in a capitalist economy de­pends on the level of effective demand.
* Thus, unemployment is attributed to the deficiency of effective demand and to cure it requires the increasing of the level of effective demand.
* By ‘effective’ demand, Keynes meant the total demand for goods and services in an economy at various levels of employment.
* Total demand for goods and services by the people is the sum total of all demand meant for consumption and investment.
* In other words, the sum of consumption expenditures and investment expenditures constitute effec­tive demand in a two-sector economy.
* In or­der to meet such demand, people are em­ployed to produce all kinds of goods, both consumption goods and investment goods.
* However, to complete our discussion on ef­fective demand, we need another component of effective demand—the component of gov­ernment expenditure.
* Thus, effective demand may be defined as the total of all expenditures, i.e.,

C + 1 +G

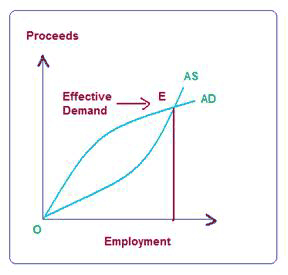
Where

C stands for consumption expen­diture,

I stands for investment expen­diture, and

G stands for government expen­diture.

* Here we ignore government expenditure as a component of effective demand.
* According to Keynes, the level of employment is determined by the effective demand which, in turn, is determined by aggregate demand function or aggregate demand price and aggregate supply function or aggregate supply price.
* In Keynes’ words; “The value of D (Aggregate Demand) at the point of Aggregate Demand function, where it is intersected by the Aggregate Supply function, will be called the effective demand.”
* We have studied separately aggregate demand and aggregate supply as the two determinants of effective demand.
* Now we will describe how equilibrium level of employment is deter­mined in an economy by using the concept of effective demand.
* The level of employment in an economy is determined at that point where the aggregate supply price equals the aggregate demand price.
* In other words, the intersection of the aggregate supply function with the aggregate demand function determines the volume of income and employment in an economy.



The above diagram explains the concept of effective demand.

**Q 12 Explain in the detail the consumption function?**

**Ans:**

* Consumption function or propensity to consume refers to the functional relationship between the aggregate consumption & aggregate income.
* Consumption function shows the changes in consumption at different levels of income.

**C = f(Y).**

Where,

C = Aggregate Consumption Expenditure.

f = function of.

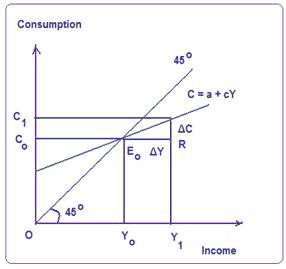
Y = Aggregate income or National income.

|  |  |  |
| --- | --- | --- |
| Income Y ( Rs. in corers) | Consumption C ( Rs. in corers ) | Savings S ( Rs. in corers) |
| 300 | 300 | - |
| 400 | 380 | 20 |
| 500 | 450 | 50 |
| 600 | 510 | 90 |
| 700 | 560 | 140 |

* The schedule shows the various amounts of consumption at various levels of income.
* The table shows that when income increases consumption also increases but in a lesser proportion.
* This is known as “Keynes Psychological law of consumption.”
* A part of additional income is not consumed and therefore saved.
* As a result of the increase in national income

1. Consumption increases at a diminishing rate.
2. Savings increases at an increasing rate.

C & Y move in the same direction & they are positively correlated.



* In the above diag line OA is income line which shows C+S.
* It is a 45° line.
* Line CC is the consumption line.
* It shows level of consumption at different levels of income.
* At point E income and consumption are equal.
* It is the break even point.

**Factors Affecting Consumption function.**

* Out of the given amount of income how much a person will spend for consumption depends upon many factors.
* They can be classified broadly into two parts:

**Subjective Factors:**

* They are internal or psychological factors. Such factors are explained as follows:

**Motive of independence:**

* If a person has a strong desire to enjoy financial independence in future then he will save more & consumption will be less.

**Motive of social prestige:**

* When a person has a strong desire to enjoy social prestige then he will save more and acquire assets.

**Motive of enterprise:**

* It refers to desire to launch one’s owns business in future.
* If a person has strong motive of enterprise he will save more.
* Thus consumption will be less.

**Motive of precaution:**

* It refers to desire to save money as precaution against future uncertainty.
* If there is strong motive of precaution consumption will be less & savings more.

**Motive of miserliness.**

* Some people gets satisfaction through savings by avoiding consumption.
* When this motive is strong consumption is less.

**Motive of calculation:**

* There are some people who calculate returns on savings.
* If this motive is stronger consumption will be less.

**Objective factors:**

* They are external factors. Such factors are explained as follows:

**Rate of interest:**

* When rate of interest is higher, consumption will be less because people will like to earn interest through savings.

**Taxation Policy:**

* If government imposes heavy taxes then anyone will reduce consumption.
* If taxes are low consumption will increase.

**Windfall gains and losses:**

* When there are unexpected sudden gains like winning a lottery prize then consumption will increase.
* But if there are unexpected sudden losses then consumption will decrease.

**War:**

* Possibility of a war will increase the consumption because the during war period there is shortage of consumer goods.
* Hence people will like to store consumer goods.

**Q 13 Evaluate in detail the concept of APC, MPC, APS & MPS?**

**Ans:**

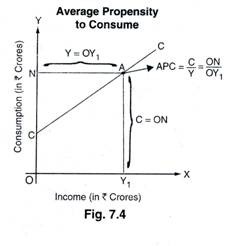
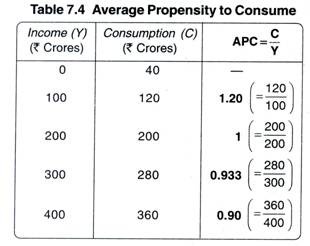
### Average Propensity to Consume (APC):

* Average propensity to consume refers to the ratio of consumption expenditure to the corresponding level of income.

**APC = Consumption (C) / Income (Y)**

* If consumption expenditure is Rs 70 crores at national income of Rs 100 crores.
* Then: APC C/Y = 70/100 = 0.70, i.e. 70% of the income is spent on consumption.

**Let us understand APC with the help of following schedule and diagram:**

**[](https://www.yourarticlelibrary.com/wp-content/uploads/2014/03/clip_image00291.jpg)**

* In Table 7.4, at the income level of Rs 100 crores, APC = 1.20.
* APC falls to 1 when income rises to Rs 200 crores.
* The value of APC further falls to 0.933 and then to 0.90.
* In Fig 7.4, income is measured on the X-axis and consumption is measured on the Y-axis. CC is the consumption curve.
* APC represents any one point on the consumption.

#### Important Points exactly APC:

#### APC is more than 1:

#### As long as consumption is more than national income, i.e. before the break-even point, APC > 1

#### APC = 1:

* At the Break-even point, consumption is equal to national income. So, APC = 1 at the income level of Rs 200 crores.

**APC is less than 1:**

* Beyond the break-even point, consumption is less than national income. As a result, APC <1.

**APC falls with increase in income:**

* APC falls continuously with increase in income because the proportion of income spent on consumption keeps on decreasing.

**APC can never be zero:**

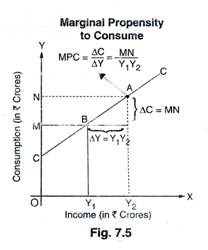
* APC can be zero only when consumption becomes zero. However, consumption is never zero at any level of income. Even at zero level of national income, there is autonomous consumption (c).

### Marginal Propensity to Consume (MPC):

* Marginal propensity to consume refers to the ratio of change in consumption expenditure to change in total income. MPC explains what proportion of change in income is spent on consumption.
* MPC = Change in Consumption (∆C) / Change in Income (∆Y)
* If consumption expenditure increases from Rs 70 crores to Rs 110 crores with an increase in income from Rs 100 crores to Rs 200 crores, then:
* MPC = ∆C/∆Y = 110 – 70/200-100 = 40/100= 0.40 i.e., 40% of the incremental income is spent on consumption.
* **Let us understand MPC with the help of following schedule and diagram:**
* **Table 7.5 Marginal Propensity to Consume**

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Income (Y)**  **(Rs Crores)** | **Consumption (C) (Rs Crores)** | **Change in Consumption (∆C) (Rs Crores)** | **Change in Income (∆Y) (Rs Crores)** | **MPC = ∆C/∆Y** |
| 0  100  200  300  400 | 40  120  200  280  360 | –  80  80  80  80 | –  100  100  100  100 | –  0.80 (=80/100)  0.80 (=80/10)  0.80 = (80/10)  0.80 = (80/100) |

* As seen in Table 7.5, MPC is 0.80, when consumption increases from Rs 40 crores to RS 120 crores with increase in income from zero to t 100 crores.
* Value of MPC remains same at 0.80 throughout the consumption function.
* Since MPC {AC/AY} measures the slope of ∆Y /∆Y
* Consumption curve, constant value of MPC indicates that the consumption curve is a straight line.
* In Fig. 7.5, MPC at point A with respect AC MN to point B = AC/AY=MN/Y1Y2



#### Important Points exactly MPC:

**Value of MPC varies between 0 and 1:**

* We know, incremental income is either spent on consumption or saved for future use.
* If the entire additional income is consumed, i.e. AS = 0, then MPC = 1.
* However, if entire additional income is saved, i.e. AC = 0, then MPC = 0 In normal situations, value of MPC varies between 0 and 1.

**MPC of poor is more than that of rich:**

* It happens because poor people spend a greater percentage of their increased income on consumption as most of their basic needs remain unsatisfied.
* On the other hand, rich people spend a smaller proportion as they already enjoy a high standard of living.
* Similarly, MPC of developing countries like India, Bangladesh, etc. is more than MPC of developed countries like America or England.

**MPC falls with successive increase in income**:

* It happens because as an economy becomes richer, it has the tendency to consume smaller percentage of each increment to its income.

**Average Propensity To Save (APS) :**

* APS is the ratio of aggregate savings to aggregate income.

**APS = S/Y.**

* Where S= Savings, Y = Income.
* As income increases APS decreases.
* The demand for capital goods depends on APS.

**Marginal Propensity To Save (MPS):**

* MPS is the ratio of change in savings to a change in income.

**MPS = ∆S/∆Y.**

* As MPC is always less than one, MPS is always positive.

**Q 14.Evaluate the concept of marginal efficiency of capital?**

**Ans:**

* The **marginal efficiency of capital** (MEC) is that [rate of discount](https://en.m.wikipedia.org/wiki/Discounting) which would equate the price of a [fixed](https://en.m.wikipedia.org/wiki/Fixed_asset) [capital](https://en.m.wikipedia.org/wiki/Capital_(economics)) [asset](https://en.m.wikipedia.org/wiki/Asset) with its [present discounted value of expected income](https://en.m.wikipedia.org/wiki/Discounted_cash_flow).
* The term “marginal efficiency of capital” was introduced by [John Maynard Keynes](https://en.m.wikipedia.org/wiki/John_Maynard_Keynes) in his [*General Theory*](https://en.m.wikipedia.org/wiki/The_General_Theory_of_Employment,_Interest,_and_Money), and defined as “the rate of [discount](https://en.m.wikipedia.org/wiki/Discounting) which would make the [present value](https://en.m.wikipedia.org/wiki/Present_value) of the series of [annuities](https://en.m.wikipedia.org/wiki/Annuity_(finance_theory)) given by the returns expected from the [capital asset](https://en.m.wikipedia.org/wiki/Capital_asset) during its life just equal its supply price”
* The MEC is the net rate of return that is expected from the purchase of additional capital. It is calculated as the profit that a firm is expected to earn considering the cost of inputs and the [depreciation](https://en.m.wikipedia.org/wiki/Depreciation) of capital. It is influenced by expectations about future input costs and demand.
* The MEC and capital outlays are the elements that a firm takes into account when deciding about an investment project.
* For example: Suppose a new machine of any existing kind would cost Rs 1,00,000.
* Technically this cost is known as supply price.
* Further suppose that this machine is expected to yield Rs 1,10,000 during a period of one year i.e the expected life the machine.
* Thus, the profitability will be Rs 1,10,000 – Rs 1,00,000 = Rs 10,000.
* Thus the profit of Rs 10,000 is expected from an investment of Rs 1,00,000.
* The rate of profitability or the rate of profitability or the rate of return would be X 100 = 10%.
* This 10% is called the marginal efficiency of capital.

MEC depends upon:

* The prospective yield i.e Rs 1,10,000 in the above example &
* Supply price of the capital good i.e Rs 1,00,000 in the above example.
* The prospective yield is the aggregate net retrun expected from the investment during its whole life.
* The supply price of capital asset is the cost of producing a new asset of that kind.
* Supply price is also called replacement cost.
* MEC can be estimated as the rate of discount that equates the prospective yield and the supply price.

**SP =**

* Where, SP = Supply price.

PY = Prospective Yield.

m = Marginal Efficiency of Capital.

n = number of years of the machine.

**Q 15. Evaluate in detail the concept of investment multiplier?**

**Ans:**

* The concept of multiplier was first of all developed by F.A. Kahn in the early 1930s.
* But Keynes later further refined it. F.A. Kahn developed the concept of multiplier with reference to the increase in employment, direct as well as indirect, as a result of initial increase in investment and employment.
* Keynes, however, propounded the concept of multiplier with reference to the increase in total income, direct as well as indirect, as a result of original increase in investment and income.
* Therefore, whereas Kahn’s multiplier is known as ’employment multiplier’, Keynes’ multiplier is known as investment or income multiplier.
* The essence of multiplier is that total increase in income, output or employment is manifold the original increase in investment.
* For example, if investment equal to Rs. 100 crores is made, then the income will not rise by Rs. 100 crores only but a multiple of it.
* So we can say Multiplier (K) is the ratio between change in Income (Y) and change in investment (I).

**K= ∆Y/∆I.**

* Keynesian concept of multiplier establishes a relationship between additional investment & additional investment & additional income & thus, it is called “ Investment Multiplier”.
* In words of Khurihara, “ The value of multiplier is in fact determined by the MPC.”
* Higher the MPC greater is the size of the multiplier & vice versa.
* The reason for this is that from the point of view of the entire economy, expenditure of one person is the income of the another.
* When investment increases income of the people also increases.
* If MPC is more, they spend large portion of their income on consumption, thereby, increasing the income of some other people.
* The increase in investment does not cause increase in income in the same proportion.
* The factor by which income increases that is the multiplier depends upon MPC
* Higher the MPC greater is the value of multiplier & thus greater the increase in income.
* In other words we can say that there is a direct relationship between multiplier & MPC.
* In the form of equation we can express it as:

**………..(1)**

We know that **Y = C+I.**

Therefore **Y = C+I** Or **I = Y – C.**

Putting the value of **I** in equation (1) we get

Dividing right hand side of the equation by Y we get

* Note that multiplier is related to MPC and not APC because multiplier shows change in income as a result of change in income, as a result of change in investment & MPC shows change in consumption as a result of change in income.
* When MPC is zero, multiplier is unity i.e 1 when MPC is unity multiplier is infinity.
* Between these two extremes value of multiplier may be determined anywhere depending on the size of MPC.
* The working of the multiplier can be shown as below:
* Process of works in two ways, with the increase in investment, multiplier increases income many times more and this is termed as the “ forward action of the multiplier.”
* On the other hand when investment decreases multiplier decreases income many times more hand when investment decreases multiplier decreases income many times more and this is termed as ” backward action of the multiplier”.
* The working of the multiplier process is based on the assumption that there exists excess capacity in the economy so that whenever consumption expenditure rises there is a corresponding increase in production.
* But in developing countries like India there is lack of production capacity.
* Hence whenever demand increases there is pressure on the existing output implying inflation rather than the increase in the output or income.
* The following diagram shows the process of income generation & working of the multiplier.

Y AS

AD1

E1 AD

Consumption

AD ∆ E

x

0 y1 y2

Income

**Q 16. Explain in detail the leakages of the theory of multiplier?**

**Ans:**

* The concept of multiplier was first of all developed by F.A. Kahn in the early 1930s.
* But Keynes later further refined it. F.A. Kahn developed the concept of multiplier with reference to the increase in employment, direct as well as indirect, as a result of initial increase in investment and employment.
* Keynes, however, propounded the concept of multiplier with reference to the increase in total income, direct as well as indirect, as a result of original increase in investment and income.
* Therefore, whereas Kahn’s multiplier is known as ’employment multiplier’, Keynes’ multiplier is known as investment or income multiplier.
* The essence of multiplier is that total increase in income, output or employment is manifold the original increase in investment.
* For example, if investment equal to Rs. 100 crores is made, then the income will not rise by Rs. 100 crores only but a multiple of it.
* So we can say Multiplier (K) is the ratio between change in Income (Y) and change in investment (I).

**K= ∆Y/∆I.**

* Keynesian concept of multiplier establishes a relationship between additional investment & additional investment & additional income & thus, it is called “ Investment Multiplier”.

**Leakages Of Multiplier.**

* The working of the multiplier which we discussed above is the only an ideal one.
* But in practice its working is best with large number of difficulties & therefore final increase in income as a result of a given increase in investment may be lower than the desired one.
* The important limitations in the working of multiplier are as follows:

**Availability of consumer goods:**

* The theory of multiplier depends upon the availability of consumer goods.
* If there is a shortage of consumer goods the income recipients will not be able to spend on consumption & hence MPC may fall & this in turn will lower the multiplier.

**Continuous net investment:**

* The multiplier effects depends upon net investments.
* Thus any act of investment in one sector of the economy is not be offset by a decline in investment in some other sector of the economy.
* Further to maintain a high level of income & employment the increments in investment are to be repeated in regular intervals of time.
* Otherwise the income will fall back to its original level.

**Multiplier period:**

* The time lag between the receipt of income or the spending of it is called the multiplier period.
* The Keynesian analysis of the adjustment between income & expenditure i.e an absence of a multiplier period the fewer are the secondary expenditure on consumption & lower will be the value of the multiplier & vice versa.

**Full employment:**

* The multiplier can work only upto full employment ceiling.
* Once the full employment is reached output & employment will stop expanding.

**Availability of resources:**

* Smooth working of the multiplier depends upon the availability of resources required for the production.
* In their absence the working of the multiplier will be affected & value of the multiplier will be low.

**Leakages in the working of the multiplier.**

* In our analysis of multiplier we have considered only savings as a leakage in the multiplier process.
* But besides savings there are other leakages in the process of income generation which reduces the size of the multiplier.
* The main leakages that occur in the process of income generation and reduced the size of the multiplier are as follows:

**Paying off debts:**

* When a part of the increase in income for paying back the debt taken by people instead of spending of consumption, the value of multiplier will be reduced.

**Holding of idle cash balance:**

* If people hold a part of their increase in income as idle cash balance & do not use it for consumption it constitutes a leakage in the multiplier process.
* Hence it restricts the value of the multiplier.

**Imports:**

* If a part of an increase is spent on imports the value of the multiplier will be less.
* Imports will not generate income & output in the domestic country but will generate income in other countries from where goods are imported.

**Taxation:**

* Taxations is another important leakage in the multiplier process because apart of increase in income may be used for payment of taxes.
* However if the money raised through taxation is spent by the government the leakage through taxation may be offset by the increase in government expenditure.

**Increase in price:**

* Price rise constitutes another important leakage in the working of the multiplier process in real terms.
* As price rise the increase in real consumption out of an increase in income will be lower than expected.
* Thus the value of multiplier will be low.

**Purchase of old stock & securities:**

* If a apart of increased income is used to purchase old stock & securities instead of consumer goods, there will be a leakage in the income generation.
* This lowers the value of the multiplier.

The above various leakages reduces the desire effects of the multiplier out of a given increase in investment. If these leakages are plugged the effect of the original increase in investment on income & employment would be great.

**Q 17 Evaluate in detail the Keynesian theory of employment?**

**Ans:**

* Keynes’ theory of employment is based on the princi­ple of effective demand.
* In other words, level of employment in a capitalist economy de­pends on the level of effective demand.
* Thus, unemployment is attributed to the deficiency of effective demand and to cure it requires the increasing of the level of effective demand.
* By ‘effective’ demand, Keynes meant the total demand for goods and services in an economy at various levels of employment.
* Total demand for goods and services by the people is the sum total of all demand meant for consumption and investment.
* In other words, the sum of consumption expenditures and investment expenditures constitute effec­tive demand in a two-sector economy.
* In or­der to meet such demand, people are em­ployed to produce all kinds of goods, both consumption goods and investment goods.
* However, to complete our discussion on ef­fective demand, we need another component of effective demand—the component of gov­ernment expenditure.
* Thus, effective demand may be defined as the total of all expenditures, i.e.,

C + 1 +G

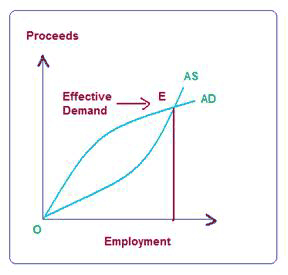
Where

C stands for consumption expen­diture,

I stands for investment expen­diture, and

G stands for government expen­diture.

* Here we ignore government expenditure as a component of effective demand.
* According to Keynes, the level of employment is determined by the effective demand which, in turn, is determined by aggregate demand function or aggregate demand price and aggregate supply function or aggregate supply price.
* In Keynes’ words; “The value of D (Aggregate Demand) at the point of Aggregate Demand function, where it is intersected by the Aggregate Supply function, will be called the effective demand.”
* We have studied separately aggregate demand and aggregate supply as the two determinants of effective demand.
* Now we will describe how equilibrium level of employment is deter­mined in an economy by using the concept of effective demand.
* The level of employment in an economy is determined at that point where the aggregate supply price equals the aggregate demand price.
* In other words, the intersection of the aggregate supply function with the aggregate demand function determines the volume of income and employment in an economy.



The above diagram explains the concept of effective demand.