Economics

The sample questions are related to the JAIBP Stage 2 course "***Economics***". The students are advised to thoroughly read the exam guidelines and the syllabus guide for this course before start studying for the paper. The questions are shared to give an idea to the student about the paper format and types of questions. For further information visit the IBP website www.ibp.org.pk

Multiple Choice Questions

Each MCQ carry one and half mark.

Q1. The bowed shape of the production possibilities curve illustrates:

A. The law of increasing marginal cost (Answer)

B. The production is inefficient

C. The production is unattainable

D. The demand is relatively inelastic

Q2. An excessive government borrowing from banking system for budgetary support would result in

A. Cost-pull Inflation

B. Demand-Pull Inflation (Answer)

C. Decrease in interest rates

D. Decrease in money supply

Q3. Which of the following is **NOT** a leakage from circular flow of income?

A. Increase in saving deposits of local banks

B. Increase in income taxes

C. Increase in domestic demand for imported mobile sets

D. Increase in public sector development expenditures (Answer)

Constructed Response Question

Each CRQ carry five marks.

Question:

Define Consumer Price Index (CPI). Brief the costs of inflation. **(5 Marks)**

Answer:

Consumer Price Index (CPI)
The CPI measures the retail prices of a fixed "market basket" of several thousand goods and services purchased by households. Each of the goods and services is given a weight in the index in proportion to its importance in the market basket.
Inflation rate (t) = CPI (t) – CPI (t-1) x 100 CPI (t-1)

THE COSTS OF INFLATION

- Money loses its value People lose confidence in money as the value of savings is reduced. This is particularly the case with rapid inflation.
- Inflation can get out of control Price increases lead to higher wage demands as people try to maintain their living standards. Businesses then increase prices to maintain profits and so it goes on.
- Consumers and businesses on fixed income lose out. They lose out because the real value of their incomes falls.
- Employees in poor bargaining positions lose out People in low paid jobs with little or no trade union protection.
- Inflation favors borrowers at the expense of savers. This is because inflation erodes the real value of existing debts. Also the rate of interest on loans may not cover the rate of inflation.
- It disrupts business planning. Although businesses are aware of what has happened to prices in the past, they cannot be certain what will happen in the next few months and years. Budgeting becomes difficult and this may affect investment.

Extended Response Question

Each ERQ carry ten marks.

Question:

A) Define Money Demand curve and elaborate how it functions. **(2 Marks)**
B) Explain any FOUR main factors that influence the demand for money. **(8 Marks)**

Answer

Part-A

The Money Demand Curve and its function
The demand curve for money relates the quantity of money demanded (transactional plus speculative or asset demand) price - the interest rate. While transactional demand is relatively inelastic with respect to the interest rate at a given GDP, speculative demand is downward sloping with respect to interest rate, the price of money. The total demand therefore negatively or downward sloping from the left with respect to the interest rate. A shift in the demand curve occur, for example, if real GDP changes, if the aggregate price level rises, if financial innovation takes place or if payment change.

Part-B
Factors affecting Demand

1. **Price level:** The quantity of money measured in current dollars' *nominal* money supply. The quantity of nominal dollars demanded is proportional to the price level. If prices go up, nominal money goes up. What in the end matters, however, is not nominal but *real* money demanded, that is, its purchasing power. Thus if prices go up 10% and income goes up 10%, nominal money has increased but real money stays the inflation tends to lower the value of money over time. The higher the rate of inflation, the greater will be the demand money today.

2. **Interest rates:** Like all commodities, the price of money is an opportunity cost. If its price goes up, producers will tend to substitute less expensive alternatives. The price of money is the interest rate. The higher the more expensive is money and the less will be demanded. Thus an alternative to holding money (the opportunity foregone) purchase an interest-earning asset.

3. **Real GDP:** In short, the higher is the level of income the greater is the demand for money, *i.e.,* the larger the economy the greater the number of transactions and therefore the greater the demand for money.

4. **Financial innovation and payment habit:** Innovations like interest-earning chequing accounts, ATMs, cards all reduce the demand for money. Similarly, if you are paid once

a year you will hang on to money increasing you are paid weekly you know there is more coming quickly and you spend or invest.