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CLEARED PRELIMS

NEXT IAS

(To be filled by candidate)

Name of Candidate : NESRIN P FASIM

Roll No. : ..... Contact No.....

e-mail:.. .. Date of Examination :.....

Exam Centre : Old Rajinder Nagar ☐ Online ☑

CSE (MAINS) TEST SERIES-2024

Test-01	ECONOMICS OPTIONAL
Dated : 30-06-2024	*(Micro and Macro Economics)*

Time Allowed : Three Hours

Maximum Marks: 250

QUESTION PAPER SPECIFIC INSTRUCTIONS

(Please read each of the following instructions carefully before attempting questions)

*There are **EIGHT** questions divided in **Two sections** and printed in **ENGLISH**.*

*Candidate has to attempt **FIVE** questions in all.*

***Question No. 1 and 5** are compulsory and out of the remaining, any **THREE** are to be attempted choosing at least **ONE** question from each section.*

The number of marks carried by a question/part is indicated against it.

Answers must be written in the medium authorized in the Admission. Certificate which must be stated clearly on the cover of this Question-cum- Answer (QCA). Booklet in the space provided.

No marks will be given for answers written in a medium other than the authorized one.

Word limit in questions, wherever specified, should be adhered to.

Attempts of question shall be counted in sequential order. Unless struck off. Attempt of a question shall be counted even if attempted partly. Any page or portion of the page left blank in the Question cum Answer (QCA). Booklet must be clearly struck off.

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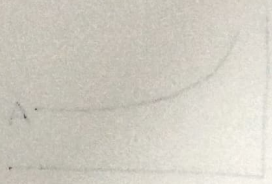
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Q. No.	Page No.	Max. Marks	Marks	Total	Signature
1. (a)	4	10			
1. (b)	6	10			
1. (c)	8	10			
1. (d)	10	10			
1. (e)	12	10			
2. (a)	14	15			
2. (b)	17	15			
2. (c)	20	20			
3. (a)	24	15			
3. (b)	27	15			
3. (c)	30	20			
4. (a)	34	20			
4. (b)	38	20			
4. (c)	42	10			
5. (a)	44	10			
5. (b)	46	10			
5. (c)	48	10			
5. (d)	50	10			
5. (e)	52	10			
6. (a)	54	15			
6. (b)	57	20			
6. (c)	61	15			
7. (a)	64	15			
7. (b)	67	15			
7. (c)	70	20			
8. (a)	74	20			
8. (b)	78	15			
8. (c)	81	15			
Grand Total					

Remarks

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Observations:



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SECTION-A

(10 × 5 = 50)

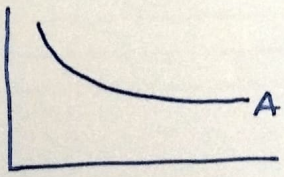
Q.1 (a) **Write notes on the following in about 150 words each:**
What are different sources of monopoly power? How can it be controlled?

Monopoly power refers to the presence of power of monopolist to have in the market.

The monopolist gets the power through:

① limited resources in the market for other players.

② Natural monopoly situation, where a person has huge fixed cost but less variable cost



③ No arbitrage possibility.

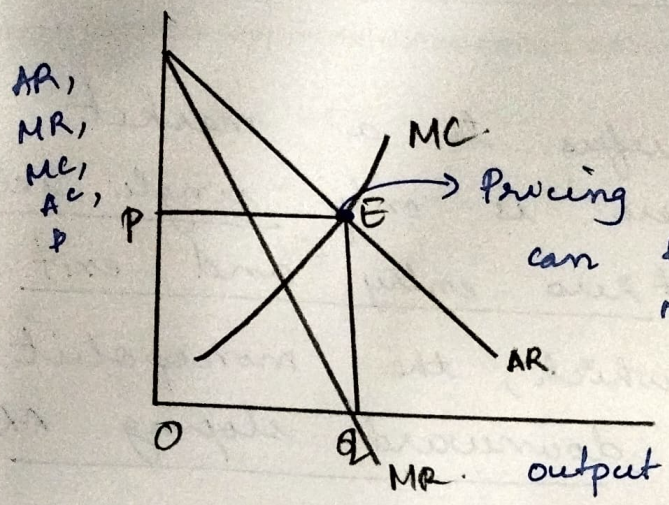
④ Reduced tariffs in other countries

The monopoly power can be restricted through the:

① Fixation of perfect competition price, P = MC by the government.

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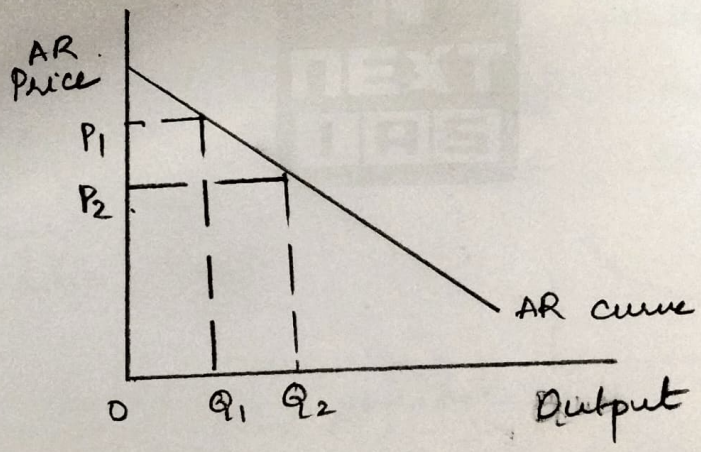


Pricing at AR = MC can help reduce monopoly power.

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Q.1 (b) Explain why there are multiple relations possible between price and output in monopoly.

Monopoly refers to a market where there is only single seller with ~~diff~~ zero entry and exit. Due to which, the monopolist has a downward sloping AR curve such that at price increases, demand for commodity decreases.



Here with increase in ~~quo~~ price, the quantity demanded will decrease

↳ MONOPOLIST'S CONSTRAINT → which means that they have to sacrifice price or quantity → in order to attain the market.

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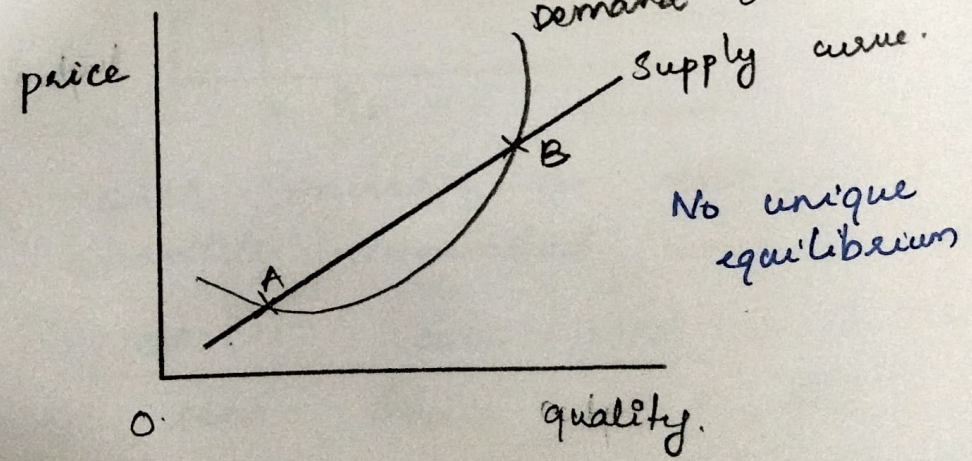
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Q.1 (c) Is it necessary that asymmetric information will have unique equilibrium?

Asymetric information refers to the market situation in which the buyers and sellers do not have perfect information about the market and as a result, there is market collapse.

The asymetric information has two cases → Adverse selection, Moral hazard.

In case of adverse selection, there won't be a unique equilibrium, this can be illustrated as:



Here the ~~qual~~ demand of a commodity ~~do~~ ~~di~~ increases first and then decreases, because of

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the reason that with no information about products' quality by the buyer, they believe that with ~~the~~ increase in quality, more price will be charged and they believe that ~~the~~ at higher price above a point, there will be decreased quality, so they demand less.

The problems of adverse selection can be solved by methods like Signalling and Screening.

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Q.1 (d) Explain diamond water paradox.

Diamond water paradox evolved as a contradiction in the ~~ordinal~~ cardinal utility theory, which states that, the marginal utility decreases with increase in consumption of each single unit of a commodity ⇒ Diminishing marginal utility theory.

In case of diamond, the theory holds opposite because with every increase in consumption of each unit, the marginal utility increases.

In case of water, the marginal utility decreases with every unit of consumption.

This is because of the fact that water is an essential commodity and with every first ~~sip~~ sip, the thirst is solved and each extra unit consumed

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doesn't provide much utility.

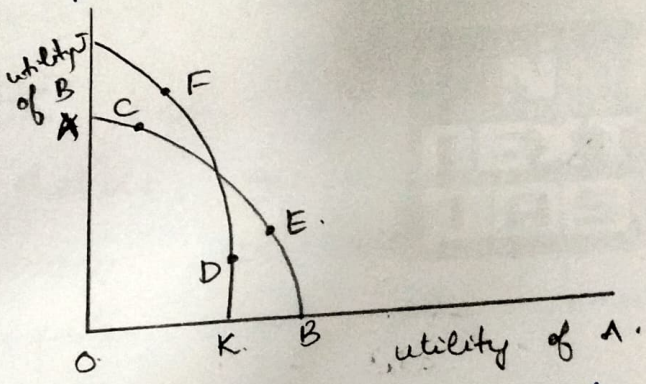
In case of diamond, since it is important as a Veblen good, its utility remains high with every unit bought.

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Q.1 (e) What is Scitovsky solution, explain the entire context.

Scitovsky's solution or Double criterion theory of welfare was formulated as a reaction to the ineffectiveness of Kaldor-Hicks compensation criterion, in some situation.

Scitovsky's criticism of Kaldor-Hicks compensation criterion:



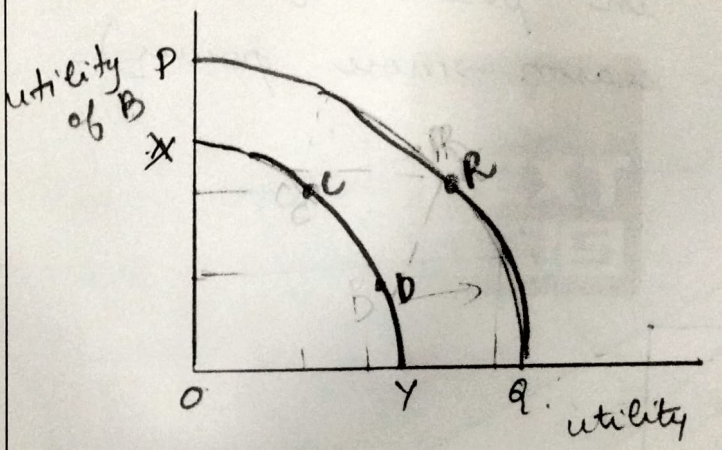
According to Kaldor-Hicks criterion, when moving from C to D, there can be movement from D to F such that the utility increase of A can compensate the utility decrease in B such that both are better off even after compensation. Accordingly this only should ideally happen. But Scitovsky pointed out that reverse is also possible, i.e., on moving from a point D to C, then the person B can compensate

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person A by such that they both can move to a point E such that A is still better off than earlier point O and both are better off.

Scitovsky said that this is a violation of the compensation criterion and he formulated his own theory of double criterion:



In this situation, all other points ~~are~~ in the XY is lesser compared to the policy space of PQ, such that an optimum solution can be reached. In this case R is superior to any other point on pareto policy space in the Utility Possibility Frontier XY in PQ.

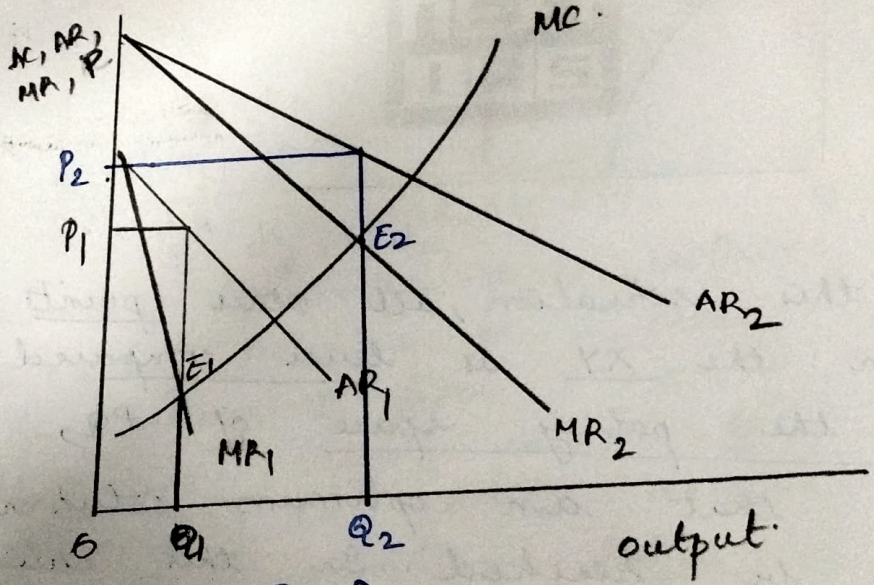
Both there evolved as a counter theory to Pareto criterion of welfare.

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Q.2 (a) How is peak load pricing a more efficient solution than normal pricing? 15

Peak load pricing is a type of price discrimination such that different pricing mechanism is undertook according to the changes in demand.

eg :- Increase in demand due to increase in power (eg. in a summer season → more power).



(Fig 1)

(Fig 1) shows peak load pricing. AR_1 is the demand curve during less peak period and equilibrium is at E_1 where

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$MR_1 = MC$ and equilibrium price is P_1 with quantity supplied OQ_1. With increase in demand, the new AR and MR are AR_2 and MR_2. The equilibrium at peak demand is at E_2 where $MR_2 = MC$ ⇒ equilibrium price at OP_2 and quantity sold is OQ_2.

This method is ~~not~~ better than normal pricing method because:

(1) Charging a high price during ~~peak~~ lesser demand conditions can make consumers with lesser income ~~not~~ excluded from enjoying the service. This case guarantees them to have access to the service.

(2) More like equitable division

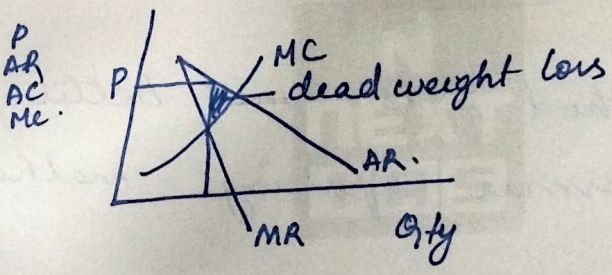
(3) More income can be

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generated at peak periods as a compensation for their large demand.

(4) Avoids discriminate price discrimination by profit motivated firms.

(5) Reduces **Deadweight loss**



Peak load pricing has applications at electricity sector, oil trade, etc.

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Q.2 (c) Explain two tier pricing in monopoly discrimination. 20

Monopoly price discrimination (PD) refers to charging different prices to different consumers for same commodities.

Types of monopoly discrimination

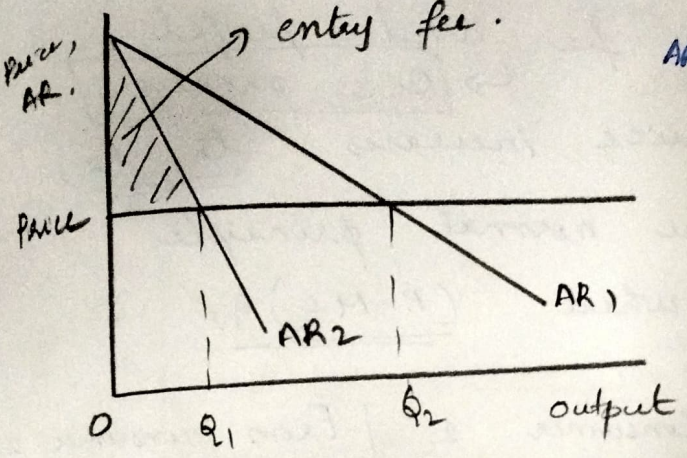
- first degree price discrimination (more consumer surplus extracted) (CS).
- second degree PD (lesser CS)
- third degree PD (lesser consumer surplus)

Two tier Pricing

⇒ It is a type of pricing in the second degree price discrimination wherein there will be two different consumers and the monopolist charges differently along with an entry price.

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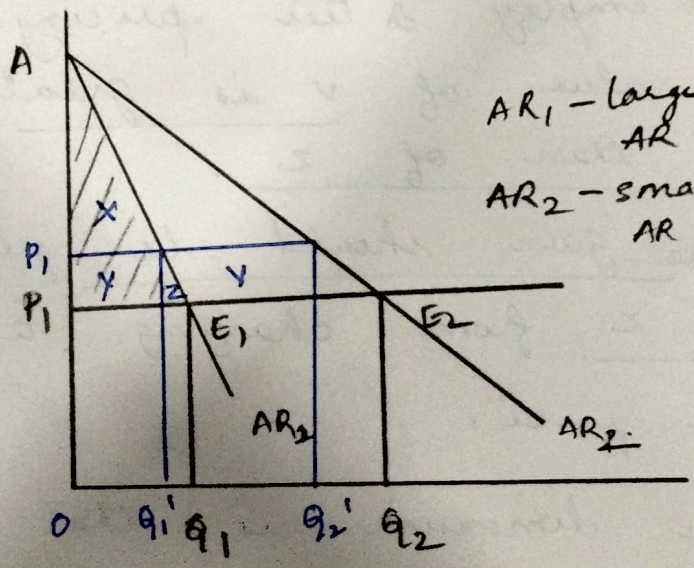


AR_1 → demand curve of rich consumer

AR_2 → demand curve of poor consumer.

In this case, entry fee is extracted from the consumers and along with that, a user fee is also incurred.

In case of a price increase:



AR_1 – large consumer's AR curve

AR_2 – small consumer's AR curve

In case of first case, the monopolist charges $\underline{A E_1 P_1}$ from both consumers and get $\boxed{2AE_1P_1}$

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as entry fee and profit.
↳ Qi's principle

Suppose price increases to P_2, the other normal principle operates where (P-MC)Q,

From consumer 1	From consumer 2
Qi°: X+Y+Z (at Q_1 output)	Qi°: X+Y+Z. (at Q_2 output)
Otherwise: X+Y → Z is lost. (at Q_1' output)	Otherwise ⇒ X+Y+Z+V (At Q_2' output) ⇒ V is gain

In this case, the monopolist will employ a tie pricing if the value of V is greater than than of Z.

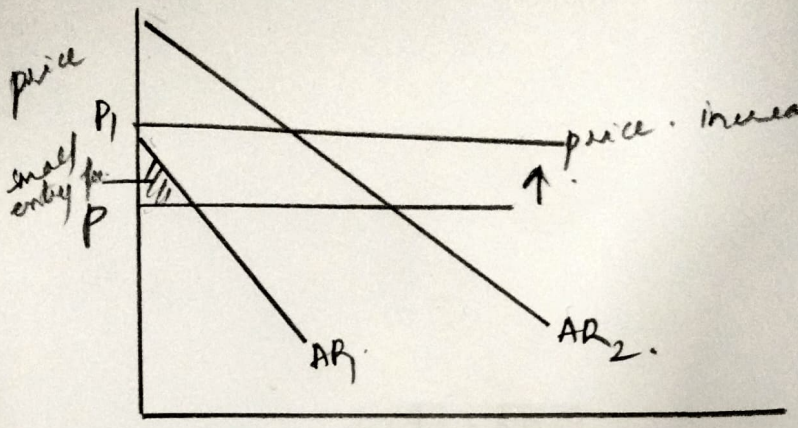
i.e., the gain should be greater than Z from charging a higher price.

Another dimension is that if the smaller consumer's AR curve is very small,

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the monopolist can ~~exte~~ exclude them by charging a higher price.



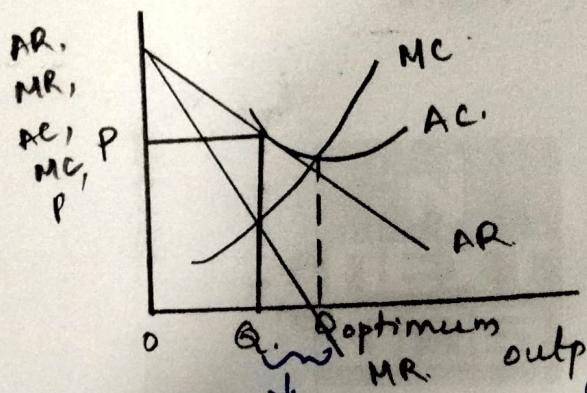
At P_1 → excludes the 2nd consumer.

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Q.4 (a) Explain the different concepts of excess capacity, highlighting differences between Chamberlin and Robinson. 20

Excess capacity arises in a non-polistic competition, mainly due to brand differentiation and differentiated products.

Normal excess capacity:



excess capacity is normal case where; difference is quantity between the original quantity and optimum quantity (minimum of AC).

Chamberlain refuted this idea and said that such as excess capacity is not true because production at minimum point of AC is possible in perfect competition, which is not a real life situation.

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He said that excess capacity can arise due to price competition in the market.

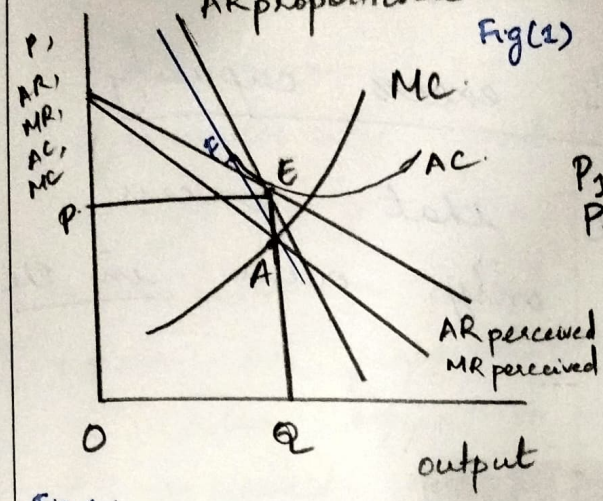


Fig (1)

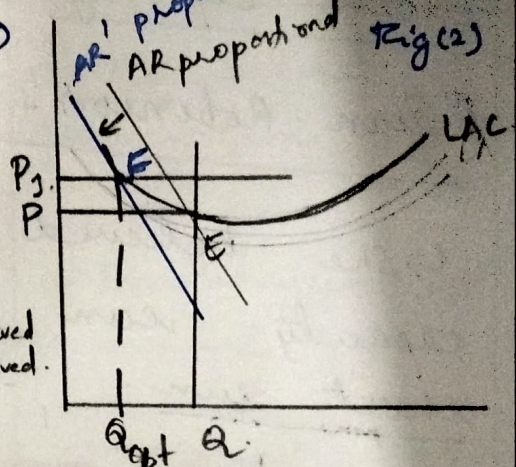


Fig (2)

Fig 1: Here the equilibrium is at A, and price at E, where where MR = MC at ARperceived = AR proportional.

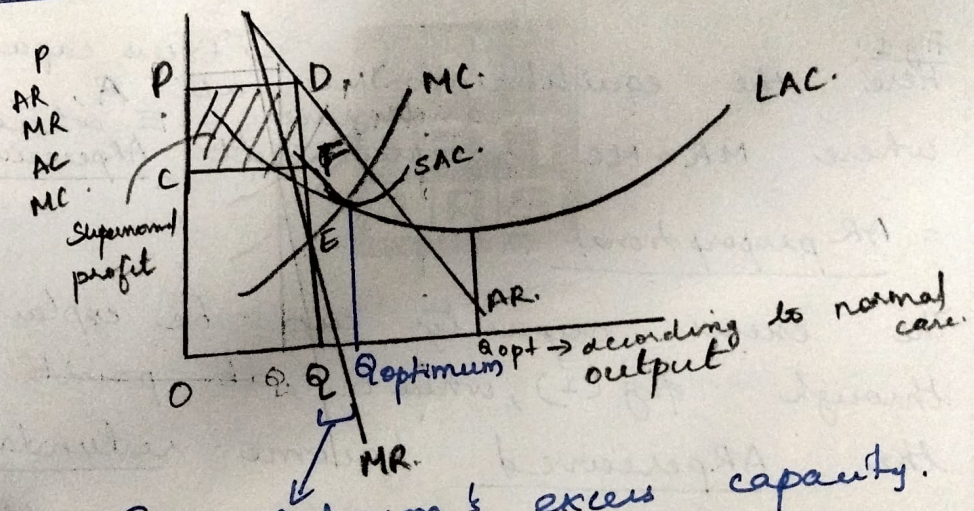
The excess capacity can be explained through fig (2), where in, ~~at point~~ the ARperceived become redundant and ARproportional is what matters, At E, ~~there~~ if price increases to P_1, then the firm can earn supernormal profit, as a result, more firms enter and ARproportional shifts to left and reaches at equilibrium where the ARproportional is tangent to

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AC curve at point F. So, to Chamberlain Qopt Q was the excess capacity.

Joan Robinson's excess capacity:

↳ She believed that excess capacity can only occur in the short run.



Joan Robinson's excess capacity.

According to her, the excess capacity is only there in the short run and not applicable at long run., i.e., at diff plo minimum point of SAC and point F's quantity (equilibrium point)

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Brief differences between these two models:

Chamberlain	Joan Robinson
↳ Assumptions of symmetricity and uniformity.	↳ No such assumptions.
↳ Equilibrium point where AR proportional is also equal to AR perceived at MC = MR equilibrium	↳ Equilibrium at marginal cost = marginal revenue in short run only.
↳ Excess capacity due to price competition only	↳ Due to short run conditions only.
↳ No much change.	↳ Later changed by followers to be at long run

These ~~x~~ theories led to an explanation of excess capacity at a different perspective and was a breakthrough in the theory of monopolistic competition.

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Q.4 (b) "Asymmetric information leads to two important problems in market solutions", examine these problems and provide solutions to them. 20

Assymetrical information refers to the problems that arise in market due to the lack of information among buyers and sellers on market conditions leading to market collapse.

Two problems

① **Adverse selection:**

This occurs due to the lack of hidden information available to the buyers.

Taking eg. of markets of plums (good used cars) and lemons (bad used cars)

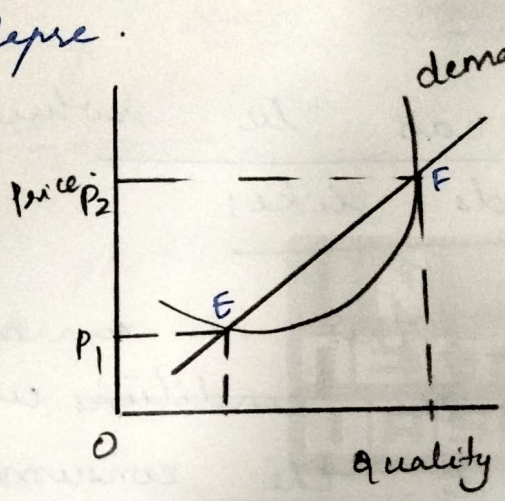
⇒ Suppose, willingness to sell lemons = ₹1800
" " plums = ₹2000
willingness to buy lemons = ₹1000
willingness to buy plums = ₹1200

The optimum solution is reached at ₹1300, wherein the sellers

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of lemon plums exit the market and the lemons remain. The buyers suffer due to this hidden information about the quality of these two types of goods & at last the market collapse.



⇒ no unique equilibrium.

② Moral Hazard :

This occurs due to the presence of perfect information about the behaviours of the buyers and the sellers, such that it ends up in no optimum solution for both.

For eg :- Insurance markets wherein the person with insurance do

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not take care of the insured products and use it in such a bad way to get maximum amount of satisfaction or results from the insurance company.

These issues can be solved using methods like:

① SIGNALLING → This is a method to improve the conditions use of signals to the consumers about the hidden information to the consumers in market.

② SCREENING → by methods like using necessary parameters to understand the quality differences.

③ ADVERTISEMENT → makes the buyers know about the qualities and take their decisions accordingly.

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④ Using income/other parameters to identify which insurers need the insurance by the insurance companies — basically filtering consumers.

⑤ Using data analytics or market analysis tools

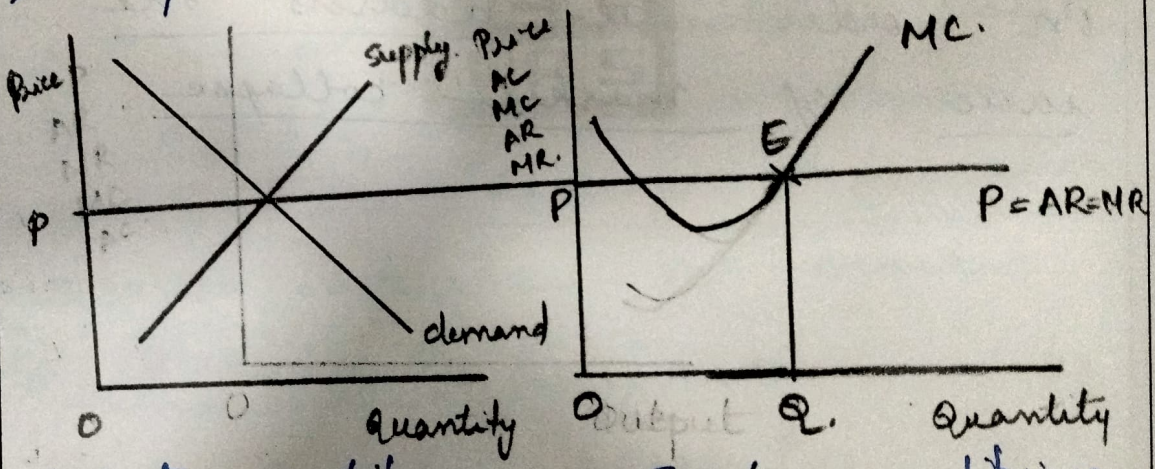
The problem of asymmetric information ~~to~~ should be solved in order to address the issue of market collapse.

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Q.4 (c) Explain producer's equilibrium in perfect competition. How is the standard result affected in case of constant return to scale production function. 10

Perfect competition is a market situation with large number of sellers and buyers dealing with homogeneous products where producer is a 'Price-taker'.

The normal producer's equilibrium takes place in perfect competition at $\boxed{\text{Price} = AR = MR = MC}$, where MC is upward sloping.



Industry equilibrium — Firm's equilibrium (Producer's equilibrium)

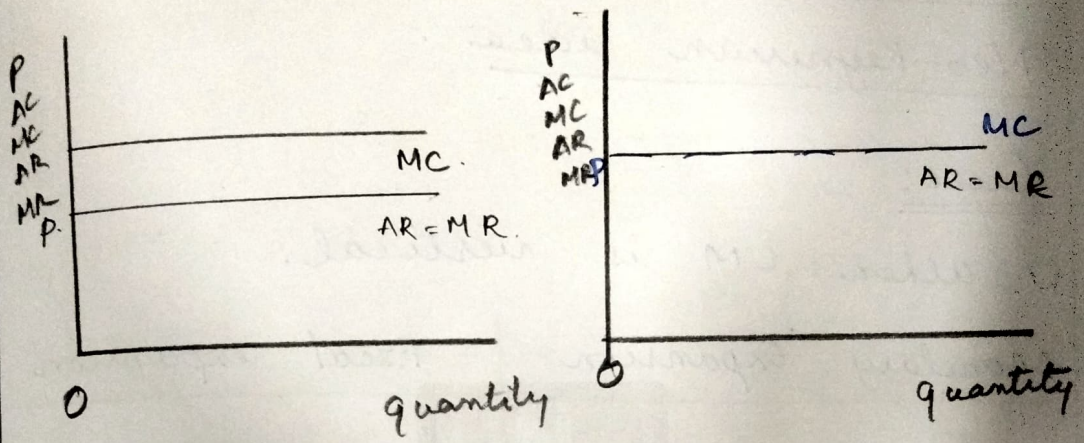
OQ → equilibrium output
OP → equilibrium price.

At E, MC is below MR and this is point where $\boxed{P = AR = MR = MC}$

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In case of constant returns to scale production function, MC becomes a constant and there will be :



No equilibrium

MC passing through MR=AR curve → multiple equilibriums

However perfect competition is not possible in real world, therefore, most of the markets have either ~~not~~ oligopoly or monopoly

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SECTION-B

Write notes on the following in about 150 words each: (10 × 5 = 50)

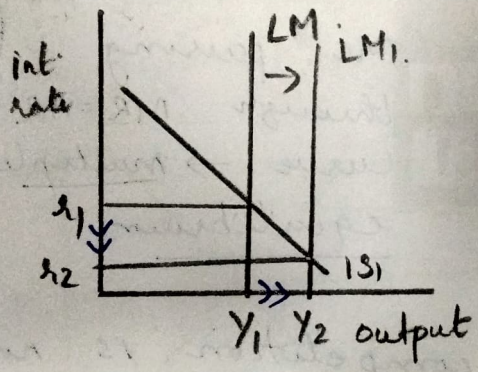
Q.5 (a) What happens if LM is vertical, in case of fiscal and monetary expansion. How will your answer change if LM is standard but IS is vertical.

IS-LM curves approach was a Neo-Keynesian idea.

Cases:

(1) When LM is vertical:

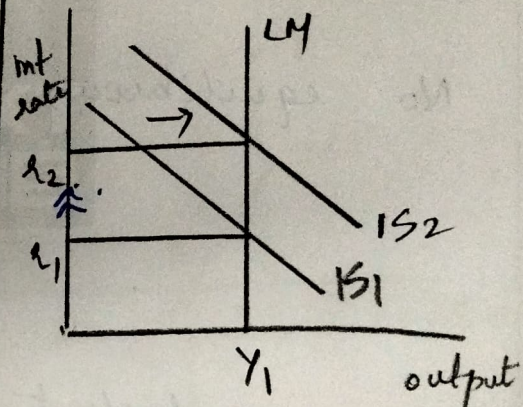
Monetary Expansion



→ Interest rate decreases → can lead to ~~crowding~~ investment ↑ and output ↑.

⇒ better transmission mechanism

Fiscal expansion



→ Interest rate increases → leads to 'zero crowding out'

→ output remains the same

∴ vertical LM hence has :-

→ Monetary policy is effective

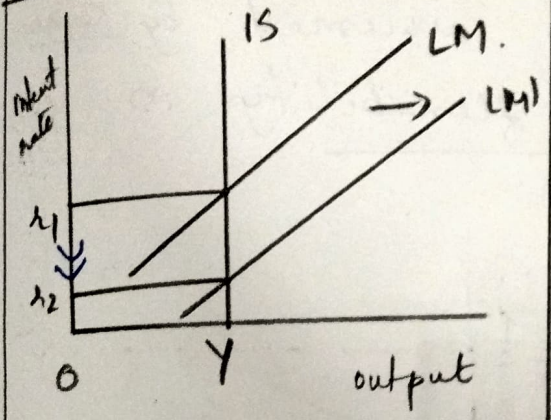
→ Fiscal policy is ineffective

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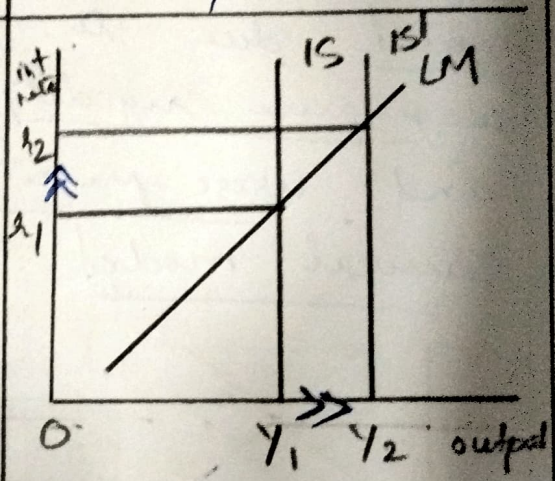
(2) LM is standard & IS is vertical

Monetary expansion



→ Interest rate will decrease
→ output remaining the same
→ No transmission mechanism.

Fiscal expansion



→ Interest rate increases
→ Output increases.

A vertical IS hence indicates:

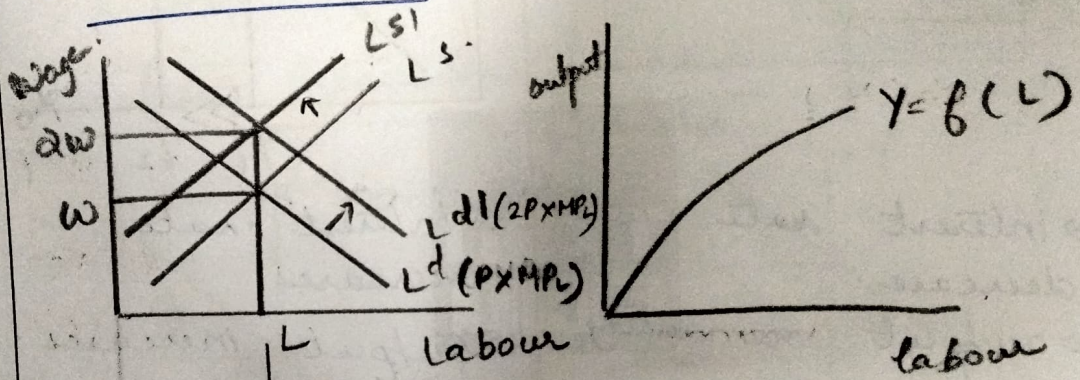
→ monetary policy is not effective
⇒ but crowding out can happen.

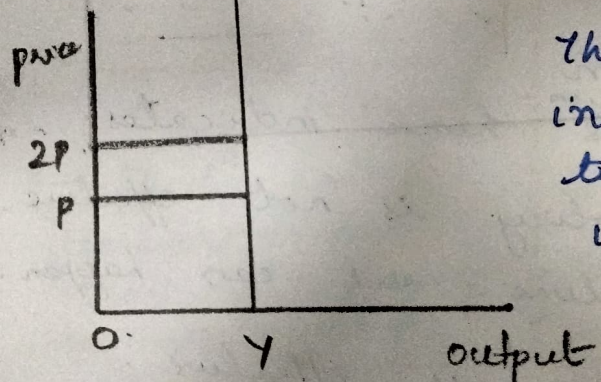
→ Fiscal policy is effective.

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Q.5 (b) Explain the shape of Aggregate Supply (AS) curve in classical model. How does it change with Keynesian approach. What are the policy implications?

Aggregate supply differs in both Keynesian model and classical model due to the reason of wage-price rigidity assumed by Keynes and wage-price flexibility in classical model



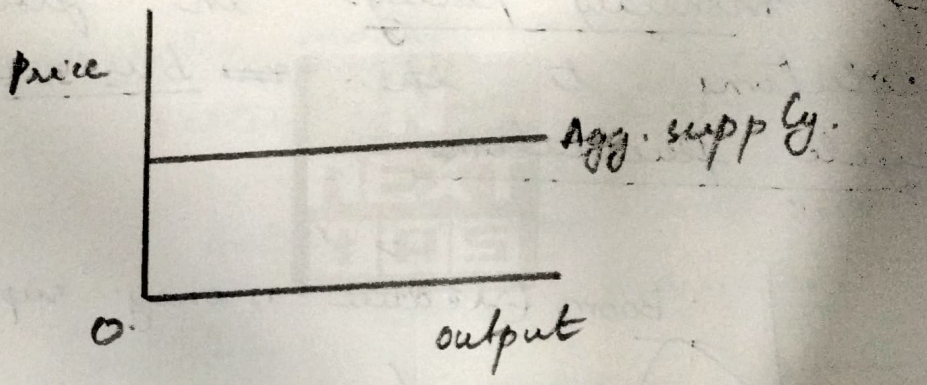


The labour demand increases and shifts to right as an increase in price, but due wage-price flexibility, the labour supply shifts to left and as a result the nominal wage increases such that the real wage remains constant → leads to vertical Aggregate supply curve.

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In Keynesian system, the Aggregate supply curve is horizontal due to wage-price rigidity, in both short run & long run because of money illusion of the workers who don't understand about real wages & consider only nominal wages



Policy implications are:

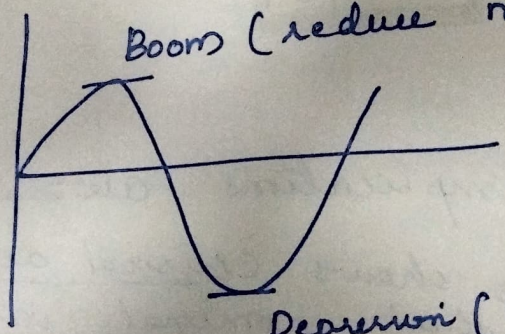
Classical AD curve → shows Classical dichotomy that nominal variables have no impact on real variables like output, only price increases.

Keynesian Aggregate supply curve → only Aggregate Demand can have an impact on economy, not aggregate supply.

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Q.5 (c) Monetarist approach cannot give a complete solution to business cycle problems. Discuss.

Monetarists approach was proposed mainly by Milton Friedman. According to the monetarists, "Monetary policy is too important to be left to Central Bank". They give importance to the role of monetary policy in providing solutions to the business cycle fluctuations



However they could not give a complete solution (especially during financial recession at 2008) due to:

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(1) Improved money supply → may result in hyperinflation.

(2) Too much contraction in money supply → crowding out → decrease in investment and output.

(3) According to them, long run, this cannot work.

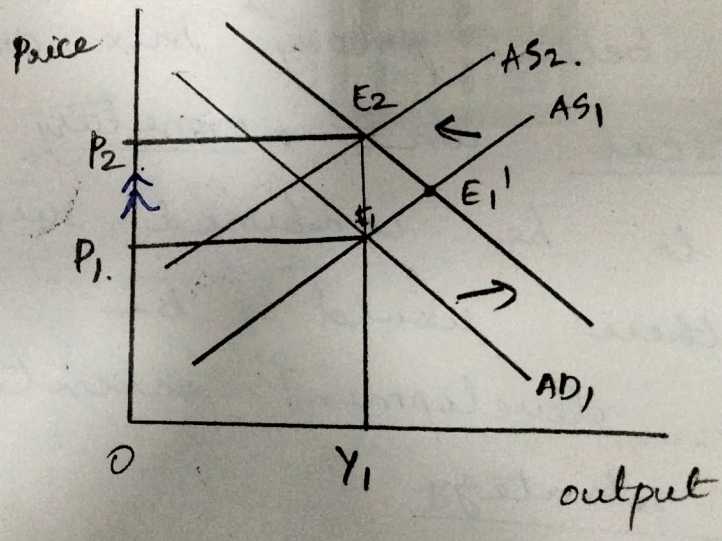
(4) "Helicopter money" → won't lead to better transmission mechanism

∴ So, a better policy mix would be fiscal and monetary policies to be combined such that there would be equitable development oriented growth strategy

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Q.5 (d) Explain how Lucas gave a solution to solving disequilibrium through temporary impact.

Lucas Jr was a proponent of Rational Expectations theory which says that if any policy change happens in the short run and if it is anticipated by the players in the market, there will not be any effect on output rather than increase in price. (with no systemic error).



Lucas said that if any policy change happens and the AD curve shifts to the right, then initially there would be a change in equilibrium E_1' & increase in output & price, but the workers

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observe this in the next time period and adjust the ~~pro~~ axes such that the aggregate supply curve shifts to left and the output will remain at Y_1 itself keeping only the price to increase.

So this theory was an improvement of Adaptive Expectation theory and destroyed the apple cart of Keynesians and Neo-classicals.

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Q.5 (e) What is hysteresis effect? Do you think the pure Keynes model will have more of it than neoclassical?

Hysteresis effect refers to the impact of a change in variable that impacts other variable for a prolonged time period; i.e., it takes time to impact a variable by another variable.

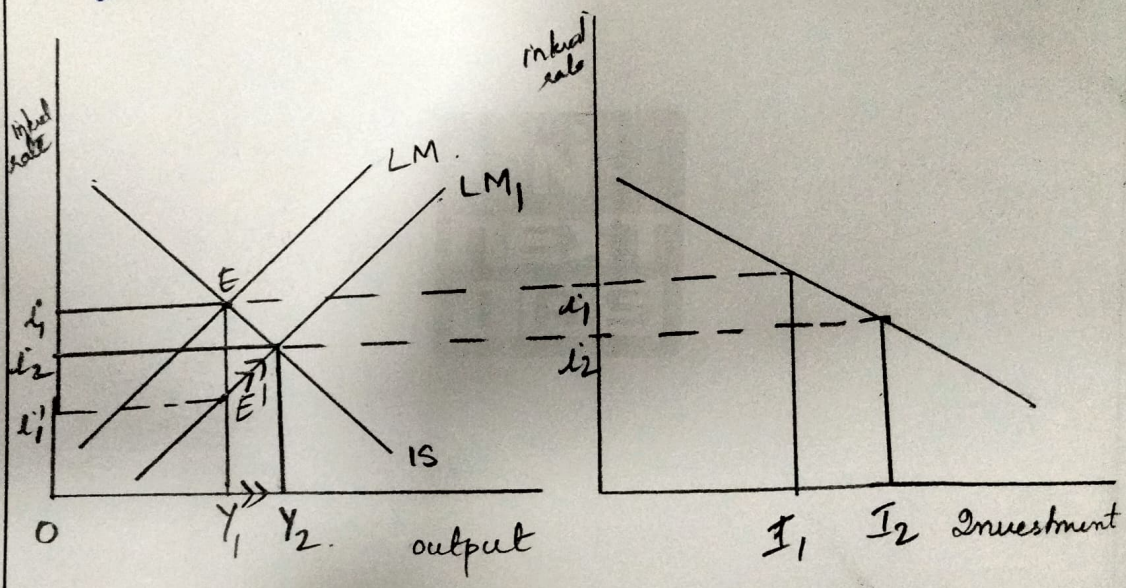
Keynes model has less hysteresis effect than that of neoclassical because for neoclassical, it is based on price expectations being adjusted slowly. But for Keynes, Aggregate demand and its change will bring a sudden impact to output & price.

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Q.7 (a) Explain transmission mechanism. How do government multiplier, k, b and h affect it. 15

Transmission mechanism refers to the effect of changes in money supply to the changes in output of the ~~market~~ system.

It essentially takes place in two stages:



The initial equilibrium is at E where IS & LM intersect and output is OY_1 & interest rate i_1.

Stage 1

Suppose, due to increase in money supply shifts the LM curve to right as LM_1, as a result at E' ~~there is~~ ⇒ for point E', there is excess supply of money ⟶ so ⇒

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inorder to match the excess money supply, the money demand has to increase by the same amount. As a result the interest rate increases to i_2 from i_1'.

Stage 2

As a result of decrease in interest rate from initial interest rate i_1 to i_2 the investment demand increases and as a result, the ~~Aggre~~ income increases from Y_1 to Y_2.

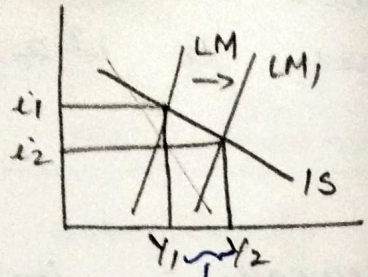
So there is better transmission mechanism such that the output has increased as a result of increase in money supply.

Effect of k, b, h on transmission mechanism

k → income elasticity
h → interest elasticity on investment (money demand)
b → interest elasticity on investment.

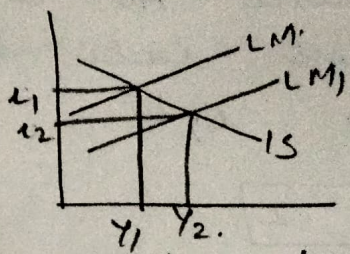
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- A smaller k can result in better transmission mechanism because



Steeper LM

larger transmission mechanism



Flatter LM.

- In case of h :- A smaller h can result in better transmission mechanism
- In case 'b' → a higher b can result in better transmission mechanism
- A higher government multiplier can result in better transmission mechanism.

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Q.7 (b) Examine Keynesian cross equilibrium. What will be his solution to great depression? Will Keynes suggest monetary solutions? 15

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Keynes put forward his theory during the Great Depression (1930s) as an explanation to be out of it when the classical notion of 'Supply creates its own demand' failed & 'Laissez-faire' failed to operate.

Keynesian assumptions →
- Wage-price rigidity.
- Aggregate supply is Horizontal.
- Perfect competition
- Presence of only voluntary unemployment.

Keynesian theory:

Aggregate Demand (AD) was defined as:

$$AD = C + \bar{I} + \bar{G}$$

where C = consumption demand

$$C = \bar{C} + cY$$

where $\bar{C}$ = MPS = $\frac{\Delta C}{\Delta Y}$

$\bar{C}$ = autonomous consumption

$\bar{I}$ = autonomous investment due to animal spirits

$\bar{G}$ = autonomous government expenditure.

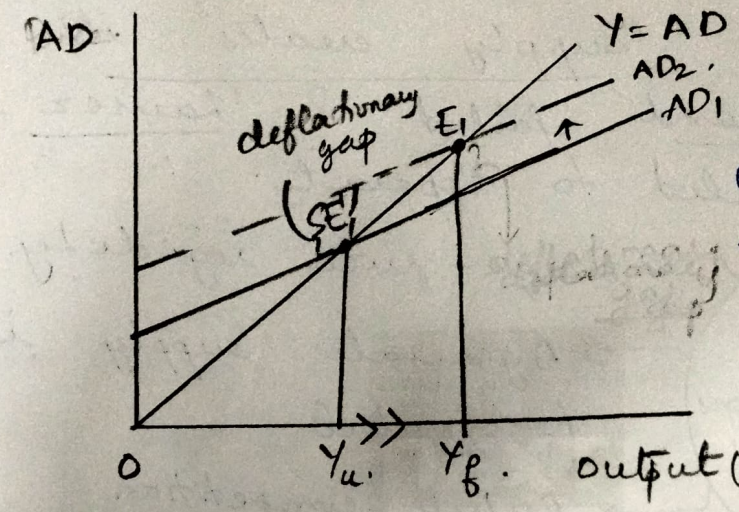
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At equilibrium,

Total income = Total expenditure

i.e., $Y = AD$

~~$Y = \bar{C}$~~ $Y = C + \bar{I} + \bar{G}$



Keynesian cross

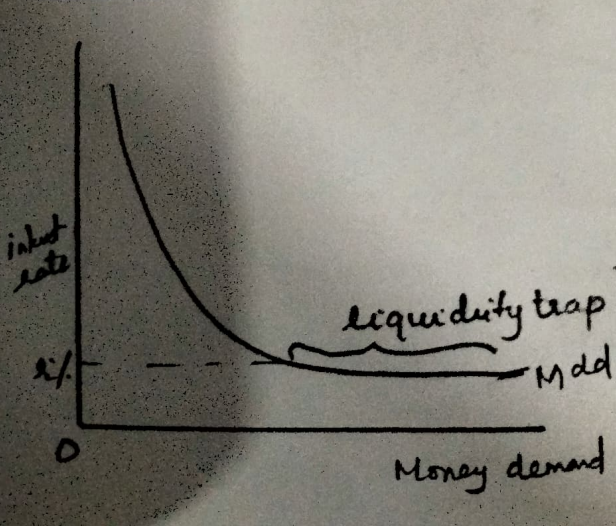
According to Keynes, At E, the potential output = original output. But during depression given Y_f as full employment, there was lack of Aggregate demand; i.e., At E, the the ~~out~~ potential output was not satisfied by the aggregate demand, as a result, the inventories has to increase, i.e., production has to be increased to reach Y_f / full employment equilibrium.

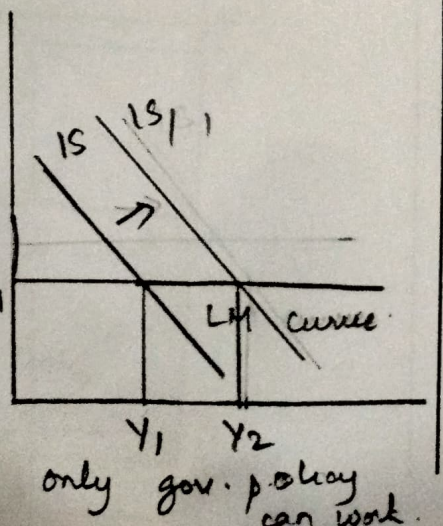
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Therefore, the Government has to increase expenditure through fiscal policy to increase Aggregate demand to reach full employment equilibrium.

Keynes suggested that in the period of depression, the speculative demand for money of people is infinitely elastic due to negative expectations such that they will hold all the money with them in hand expecting that in future bond prices may fall in future & there won't be any decrease in interest rate further down. This results in liquidity trap and monetary policy won't work in short run



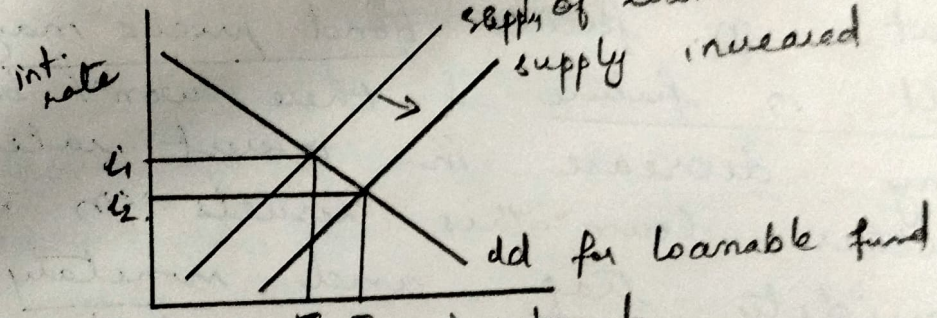


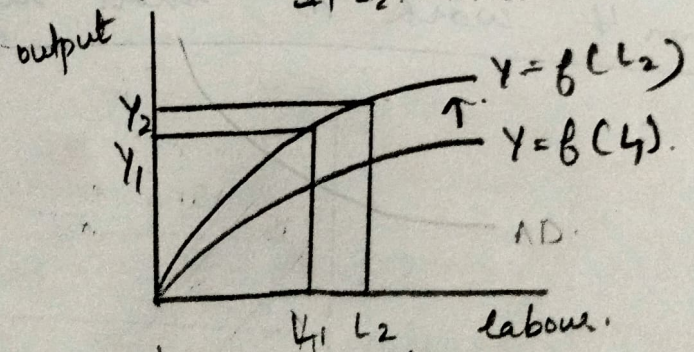
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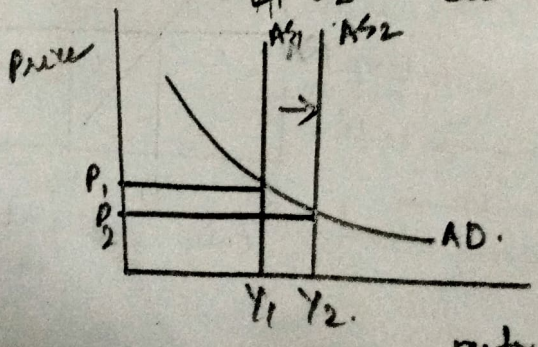
Q.7 (c) "The Keynesian view on role of saving didn't match the classical idea". Discuss. 20

The Keynesian view on savings differs from classical idea on the basis of explanation that Classicals said that an increase in savings can increase output in the economy whereas for Keynes, it will result in decrease in output - called Paradox of thrift.

Classical case:







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This is because as savings ↑ → capital stock ↑ → Marginal product of labour increases → production function becomes steep and shifts upwards → labour productivity ↑ → Aggregate supply ↑ and output increases.

Keynesian idea of ~~thrust~~ savings:

According to Keynes,

Income = Consumption + savings

$Y = C + S$

$S = Y - C$ ~~$\div$ $C = \bar{C} + c(1-Y)$~~

~~$S = Y - \bar{C} - c(1-Y)$~~ $\div$

~~$= -\bar{C}$~~

~~$= Y - \bar{C} - c - cY$~~

~~$= -c$~~ $S = -c + Y(1-c)$

$\therefore C = \bar{C} + cY$.

$S = Y - C$

$S = Y - \bar{C} - cY$

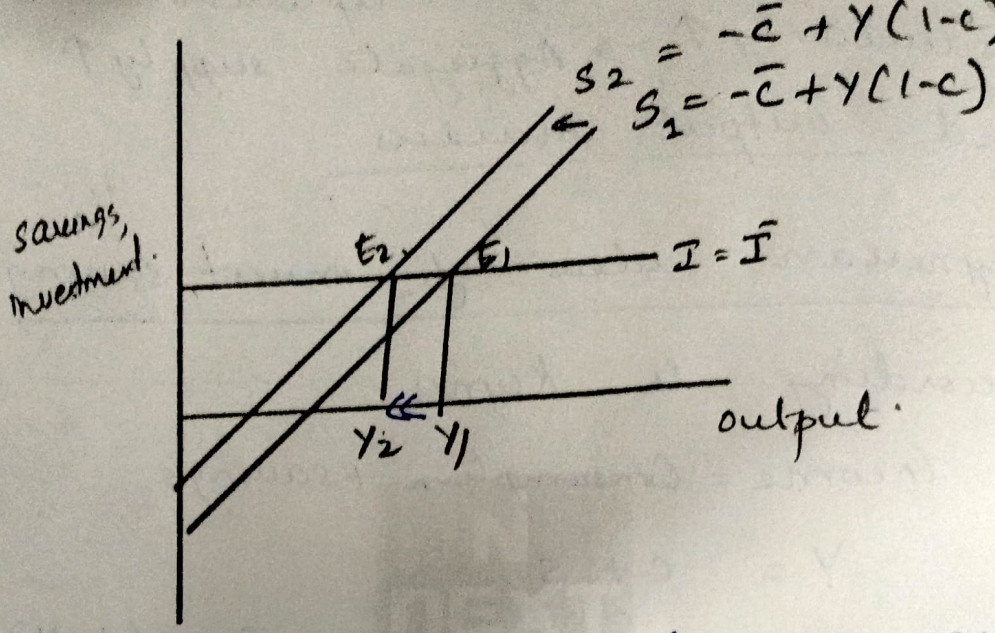
~~$S = -c + c(1+Y)$~~

$\Rightarrow \boxed{S = -\bar{C} + Y(1-c)}$

- Also investment is not a function of interest rate, but due to animal spirits, where

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investment is due to behaviour of bulls & bears in the stock market.



The figure shows that as savings increased from S_1 to S_2, the curve shifts to left as a result, the output has decreased.

This explains Keynesian idea of paradox of thrift thus do not match with Classicals who believed that an increase in savings always resulted in the ~~dec~~increase on output.

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This is due to the fact that Keynes relied on autonomous investment function wherein the interest rate doesn't affect investment. It is the behaviour of bond holders that affect the savings and hence the output.