Civil Services (Main) Examination, 2013

ECONOMICS
(Paper I)

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**.

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

Questions 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.

Attempts of questions shall be counted in sequential order. Unless struck off, attempt of a question shall be counted even if attempted partly.

SECTION 'A'

1. Answer the following in about 150 words each: 10×5=50

(a) Consider a perfectly competitive exchange economy with no production, and two different goods 1 and 2. Let p_1 and p_2 be the prices of the goods. The economy is populated by two people A and B. A's initial endowment of the two goods is given by (w_A^1, w_A^2), and B's initial endowment is (w_B^1, w_B^2). A can choose any bundle (x_A^1, x_A^2) and B can choose any bundle (x_B^1, x_B^2). In this pure exchange economy write out the conditions for a Walrasian equilibrium. Show that for such an economy for any equilibrium set of prices that the absolute price level is indeterminate.

(b) Kaldor in his theory of distribution argues, unlike Kalecki, that it is not reasonable to neglect the constraint of labour shortage, and analyse a situation of full employment. Show how investment and savings propensities determine distributive shares in the Kaldor approach. Suppose that investment is not exogenous as in Kaldor's original model but that it varies with profits. What does this mean for the stability of the Kaldor model of distribution?

(c) Explain the determination of output and employment in a macroeconomy under the conditions when individuals are subject to (i) no money illusion, (ii) money illusion.

(d) An individual finds that all his receipts (including income) and payment transactions are in the form of money that bears no interest. However, he can convert money into bonds and earn interest income but that involves a fixed cost of each conversion transaction. What are the determinants of the individual's demand for holding money?

(e) Suppose an industry is characterized by the following three conditions: (i) there are a large number of small firms, each producing a differentiated product and facing a downward sloping demand curve; (ii) each firm ignores the effects of its actions on the decisions taken by other firms; and (iii) new firms producing close substitutes for the product of the existing firms can enter the industry. Then, derive the equilibrium conditions of an individual firm and of the industry.

2. (a) Under Bertrand price competition with homogeneous products in an oligopoly demonstrate how is the equilibrium price that will prevail arrived at? 25

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(b) Let the market demand curve for carbonated water be given by $P = 20 - \frac{9Q}{2}$ where P is the price and Q is the market output. Let there be two firms producing carbonated water, each with a constant marginal cost of INR 2, or, $c_1 = c_2 = 2$. What is the market equilibrium price and quantity when each firm behaves as a Cournot duopolist? What are the firms' profits? What is the market equilibrium price and quantity when each firm behaves as a Bertrand duopolist? What are the firms' profits? 25

3. (a) If workers supply labour on the basis of an expected real wage, how is the aggregate supply of output determined in the economy? Suppose aggregate demand and supply are below the natural rate of employment and output. Would the New Classical economists advocate any particular policy intervention when the economy is in such a situation? 25

(b) What are the main goals of a central bank? What are the instruments by which the central bank manages the liquidity in the financial system and how does it use these instruments to achieve its goals? 25

4. (a) Macroeconomics is usually approached via the outcomes of economic interaction in the following four markets – commodities, money, bonds, and labour markets. The Classical economists focused on which three of these four markets? In which market does the loanable fund theory of interest rate determination of the Classical economists focus and how is the interest rate determined? The Neo Classical synthesis focuses on which three markets? In which market is the interest rate primarily determined in the liquidity preference theory? 25

(b) After 2003 till 2008 many emerging economies including India received huge capital inflows. To contain the effect of these flows the central bank sterilized the inflows. What is sterilization and how does it affect the supply of money in the economy? 25

SECTION 'B'

5. Answer the following in about 150 words each: 10×5=50

(a) What are the three basic goals of public finance? Can these goals be coordinated into an overall pattern of policy or are they always in conflict?

(b) What is an offer curve in international trade? For two countries engaged in trade in two goods, draw the offer curves such that the offer curve of the home country has a section reflecting inelastic import demand and the foreign country's offer curve is elastic throughout. Indicate in your diagram which part of the home country's offer curve is inelastic. What is the reason for this shape of the offer curve? Suppose the home country imposes a tariff on imports. Demonstrate the implications for trade.

(c) Summarize the main arguments of the trade optimists and trade pessimists with regard to trade policy for developing countries. Which argument does the data tend to support?

(d) State five reasons that support government intervention in agricultural markets.

(e) Expand on the following three explanations for the Kuznets hypothesis about inequality and development–(i) the cohort size hypothesis, (ii) the effect of openness on inequality, and (iii) the strong versus the weak version of the hypothesis.

6. (a) Suppose a given yield of tax is to be obtained from an excise on a particular product in a perfectly competitive industry. If the objective is economic efficiency the government would prefer that tax which obtains the desired yield with a lesser increase in the price. Should the government impose a unit tax or an ad valorem tax if the objective is that they should both impose the same burden at the initial price before the imposition of the tax? Demonstrate your answer with a diagram. 25

(b) What is rent seeking? Consider a proposal by a government to levy a proportional tax

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on income so as to subsidize the consumption of a good. The proportional tax at a rate t reduces the wage received to $w(1-t)$ which with a standard upward sloping supply of labour curve will reduce the hours of labour worked from say L_2 to L_1. The net income of the person falls and tax revenue will be twL_1. This is transferred as a subsidy which reduces the price of the subsidized good from P to $P-S$ and increases the quantity demanded from Q_1 to Q_2. What is the valuation of the subsidy by the recipient? Is it equal to the value of taxes paid to finance the subsidy? If the tax payer decides to devote resources to rent seeking to forestall the policy to subsidize the good and the subsidy recipient is also willing to devote resources to encourage the adoption of the policy, who will have the advantage in the rent seeking context? 25

7. (a) Suppose the goods, financial, current account and foreign exchange markets are initially in equilibrium. The economy has low or imperfect capital mobility and operates at a fixed exchange rate. The economy is subject to a favourable demand shock that raises expenditure. What is the outcome of the shock on the aggregate income and interest rate in the short-run? How is the balance of payments equilibrium achieved? Draw a diagram in support of your answer. 25

(b) What is a speculative attack on a currency? Suppose the economy has a fixed exchange rate and the government is following an expansionary macroeconomic policy. The government increases the budget deficit which it finances through a monetary expansion. How does this lead to a crisis? What is the timing of the speculative attack? 25

8. (a) Explain the Lewis model of structural change from an agricultural economy to a modern industrial economy. State three major criticisms of the Lewis model. 20

(b) It is said that a characteristic of the Harrod-Domar model is that even for the long run the economy is at best balanced on a knife-edge of equilibrium growth. Explain the Harrod-Domar model and the reason for this characteristic. 15

(c) What are the two key conclusions of the Heckscher-Ohlin model of international trade? Under what assumptions are these conclusions arrived at? 15

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