(a) Explain how economists measure the way in which demand for a good changes when income changes and, with the help of a diagram, show why some goods are classified as 'inferior goods'. [8]

(b) Discuss how useful governments might find the concepts of price and income elasticity of demand when setting economic policy. [12]

a) The relationship between the quantity demanded of a product with consumers' incomes is known as income elasticity of demand.

Mention the formula for YED = % change in QD / % change in Income

The quantity demanded for a product can have a positive or negative relationship with consumers' incomes. Which means for some products higher incomes result in higher quantity demanded and vice versa for other products higher incomes result in lower quantity demanded.

Products for which Q.D increases due to rise in incomes are known as normal goods for instance air tickets, expensive clothes, shoes. Within normal goods there are 2 further classification of goods namely more elastic and less elastic.

Air Tickets and Food

More Elastic products any increase in consumer's income will result in more than proportionate change in quantity demanded of the product.

Inferior goods are for which any increase in consumer's income decreases their demand. For instance, cheaper versions of any product.

b) Explain PED.

It is a formula that captures change in demand for a product due to change in its price.

Government Policy Tools

1. Indirect Taxes -

2. Subsidies
3. Income Taxes (Direct Taxes)

If demand is less elastic compared to supply like for basic necessities then it is easier for producers to transfer the burden on consumers and therefore its the consumers that face greater burden of tax.

On the other hand when supply is less elastic than demand then it is the producers who face more burden of indirect tax.

(a) Using examples, explain the difference between merit goods and public goods and show why it is possible for profit to be made in the supply of one of these types of good but not the other. [8]

(b) Discuss why merit goods are undersupplied in a free market economy and consider the effectiveness of **one** policy to deal with this problem. [12]

a) Define Merit Goods and Public Goods

Merit good is a product that is beneficial for consumers but since they underestimate the benefit they underconsumed the good.

Public goods are products that are non-excludable and non-rivalry.

Non-rivalry means when the benefit from the consumption of the product does not diminish as more consumers start using the good.

Examples of pure public goods
1. Roads
2. Defense
3. Parks
4. Street Lights

Why cannot businesses make profit on public goods?

(a) Explain how a declining exchange rate and a high rate of inflation in an economy might affect that economy's terms of trade. [8]

(b) Discuss the advantages and disadvantages to an economy of a fall in that economy's terms of trade and consider whether the overall effects are likely to be beneficial. [12]

Terms of Trade: It is a formula / calculation that records a country's exports and import prices.

4 (a) Using examples, explain the instruments of monetary policy and supply-side policy. [8]

(b) Discuss the advantages and disadvantages of supply-side policy and consider its effectiveness

in an economy that is facing a labour shortage. [12]

Monetary policy of a country is devised by its central bank which is autonomous and works without any other government department's influence or advice.

Monetary policy is about money supply and interest rates which affect the country's exchange rate, economic growth and other economic variables. Money supply is the total supply of currency notes and bank loans which are issued in an economy during a certain time period.

4 (a) Explain what is used as money in a modern economy. Consider how an increase in the money supply can cause inflation. [8]

(b) Discuss the consequences of high inflation. Consider whether the internal consequences can ever be more serious than the external consequences in an economy that has extensive foreign trade. [12]

Money is any commodity that is used as a medium of exchange. In the modern economy, currency notes (cash), cheques, bank loans, debit and credit cards are all classified as money since they allow people to buy desired goods and services.

The money supply of a country is classified in 2 categories: narrow money supply and broad money supply. Narrow measure includes bank deposits and currency notes in circulation (basically the cash that the country's central bank has printed). And the broad measure of money supply also includes bank loans and credit cards.

Narrow Measure = Cash in circulation + cash lying in banks in the form of bank deposits
Broad Measure = Narrow measure + Bank loans (credit card and other bank loans)

When the central bank prints more currency notes, more cash becomes available to the country's citizens with which their purchasing power increases and therefore it leads to an increase in aggregate demand.
Interest rates are determined through demand and supply of loans.

Internal Consequences of Inflation: high prices leading to reduced purchasing power (real incomes) - lower living standard, demand for normal goods especially luxury goods would significantly decrease, high inflation can also lead to recession - people would become more careful with their spending and so AD would decrease, secondly producers not being very optimistic about the future would also cut on their investment levels further decreasing the AD and causing recession.

External Consequences of inflation: lower exports (our country's products would become less competitive), BOP deficit,

3 **(a)** Explain the factors that are likely to make the supply of a product relatively price inelastic. [8]

(b) Discuss the ways in which businesses might attempt to increase the price elasticity of supply of their products. Assess whether these attempts are likely to be successful. [12]

a) Price elasticity of supply is a formula that calculates responsiveness of quantity supplied of a product due to change in product price.

The formula of PES is percentage change in quantity supplied divided by percentage change in product price.

What is Price Inelastic?

Price inelastic supply is when the percentage change in quantity supplied is lower than the percentage change in product price. When the product production is difficult to be increased and decreased due to change in price it is known as price inelastic.

Factors that cause inelastic supply are as follows:

1. ***Less spare capacity:*** spare capacity is the difference between maximum output and current level of output.
2. ***Shortage / limited supply of raw material / labor:***
3. ***Complicated production / time it takes to produce a good:*** if we compare production of fighter jet with a car, we know that fighter jet require more technology and skilled labor which would be difficult to arrange and so a limited number of fighter jets can be produced within a certain time period.
4. ***Locally versus imported product:***
5. ***Any particular production requirements like for agricultural products which can only be grown in certain seasons:***

b)

(a) Explain how a country's balance of payments is organised to account for all its international transactions. [8]

(b) A country has a deficit on the current account of its balance of payments. Discuss whether this is necessarily harmful to the country. [12]

a) Define BOP
The 3 accounts of BOP
Current Account

1. Trade in Goods
2. Trade in Services
3. Income
4. Current Transfer

Capital Account

Financial Account

1. Direct Investment
2. Portfolio Investment
3. Other Investment

Change in Reserves - final balance that shows the overall balance of BOP. For instance, if a country experiences surplus then there would be an increase in reserves and vice versa.

b) Why or how a country faces deficit on its Current Account
Is a deficit on the current account ***necessarily*** harmful

Because

1. More imports than exports (weak trade position)
2. More income outflows than inflows
3. More remittance going out of a country than is coming in

Current Account Deficit is Bad	***Current Account Deficit Not Bad***
Due to more imports and less exports the demand for your currency would be less and supply would be more causing the ER to depreciate.	With weaker ER, in the LR, the country's exports would become more price competitive. Resulting in higher exports.
The price of imports of the country would increase causing imported inflation.	Sometimes a country is imported capital goods for investment purposes and therefore even though in short run there would be a deficit on the country's current account but in the longer run due to improved production potential the country could have more export potential.
A possible reason for poor trade performance could be less competitive exports like the product quality is low and limited range of products are being exported.	Poor trade performance can incentivize producers to produce more quality products in future.
Constant deficit is harmful since that would cause depletion of foreign currency reserves and could build on a country's international debt.	More income outflows mean that initially more investment came in Pakistan, through business or personal investment, which shows foreigners' confidence in our country's economy and so that would result in surplus on capital and financial accounts of the country.

(b) Outline the current account position of your country or another economy you have studied. Discuss its ability to improve its performance on the current account. [12]

Every year Pakistan faces a current account deficit due to negative trade in goods and trade in services. On the other hand, we have a positive balance on income and the current transfer section.

Supply side policies