JAIPURIA INSTITUTE OF MANAGEMENT, NOIDA
PGDM / PGDM (M) / PGDM (SM)
SECOND TRIMESTER (Batch 2020-22)
END-TERM EXAMINATION, FEBRUARY 2021

Course Name	Business and Economic Environment	Course Code	ECO201
Max. Time	2 hours	Max. Marks	40 MM

SECTION I (WEIGHTAGE 20)

INSTRUCTIONS

- **All questions are compulsory.**
- **All questions carry equal weightage (4*5= 20 Marks)**

Read the following excerpts and answer the questions that follow.

<u>Fiscal policy must play a bigger role to keep our economy going</u>
(Excerpt from an article published in Livemint, November 3, 2020; Source: https://www.livemint.com/opinion/columns/fiscal-policy-must-play-a-bigger-role-to-keep-our-economy-going-11604413544870.html)

The weekly monetary data released by the Reserve Bank of India (RBI) also shows that net RBI credit to the government began to fall after July. The latest fiscal numbers—though September is likely to be an outlier—show that monetary policy continues to do much of the heavy lifting, despite persistently high inflation. Fiscal policy has so far focused largely on protecting the supply side of the economy, with credit guarantees, food distribution, and basic income support.

The balance between fiscal policy and monetary policy—as well as the coordination between the two—is a tricky issue. Much depends on the situation. Here is a general point. Most of the theoretical insights as well as policy attitudes on monetary policy were developed in response to an inflation crisis in advanced economies in the 1970s. For example, average US inflation between 1971 and 1980 was 7.86%, including three years of double-digit growth in consumer prices. The average inflation rate in the past 10 years has been 1.76%. Much of today's monetary policy practice was built around the 1970s challenge of curbing aggregate demand to bring inflation under control. It is an open question whether the same tools are as effective in pushing up aggregate demand, especially when there are large shocks such as the one the world economy experienced this year. That is why fiscal policy will have to play a more important role in case the ongoing economic recovery runs out of steam.

The need of an exit strategy from monetary expansion

(Excerpt from an article published in Livemint, December 29, 2020; Source: https://www.livemint.com/Search/Link/Keyword/-The-need-of-an-exit-strategy-from-monetary-expansion)

The scale of monetary expansion this year has not been matched since the middle of the 1980s, when Indian monetary policy began to come into its own. The size of the Indian central bank's balance sheet has increased by ₹14.2 trillion since December 2019—from ₹42.6 trillion to ₹56.8 trillion. As a proportion of nominal gross domestic product (GDP), this is close to the highest level seen over the past 35 years. The RBI balance sheet has ranged between 18-30% of GDP since 1985. The average has been 22%. It is right now at the higher end of the range, having increased by about eight percentage points since December 2020. The consequences of this are unclear—more about that later in the column—but it is a fact that 2021 could be unlike any other in recent history as far as monetary policy is concerned. The need to soak up excess dollars from India's balance-of-payments surplus, as well as to partially support the government borrowing programme, will likely add to the size of the RBI balance sheet over the next few quarters. Money supply will also increase rapidly. What this means is that a sustained increase in the size of the RBI balance sheet will take monetary policy into uncharted waters next year. However, the assets of RBI are still modest compared to the central bank balance sheets in other large economies such as the US (34%), China (38%), the Eurozone (67%) and Japan (138%). These large economies have seen massive increases in their balance sheets in recent years. The pace picked up further in the pandemic year. The assets of these big four central banks had collectively increased by an annual rate of 52% by November, with $8 trillion added to their books over 12 months. The big difference is that Indian inflation is far higher than inflation in these countries, and has been above the upper end of the official target range for eight months in a row.

The rapid expansion of money supply this year has been driven by an increase in RBI's foreign exchange reserves and a rise in government securities held by the central bank. The former has been far more important than the latter. This means that the Indian central bank has not had to support the fiscal deficit to the extent that many, including me, had expected in the early months of the pandemic, when it seemed that RBI would have to aggressively monetize the government's fiscal deficit. The most likely reason that the fiscal deficit has been funded by financial markets rather than the central bank is that time deposits in banks have shot up by ₹ 10 trillion since April, as people saved more either as precaution or because they could not spend during the severe lockdown. With a surge in bank deposits combined with weak credit growth, risk-averse bankers were happy to lend to the government. That took some pressure off RBI. The sharp increase in time deposits as well as the demand for currency have been important drivers of money supply growth when one thinks of its components.

The increase in the balance sheet of the country's central bank, as per the traditional view is that it will add to inflationary pressures in the Indian economy. The weighted average call money rate—which is the operating target of monetary policy under flexible inflation targeting—has been below the reverse repo rate since the last week of October. Collaterized rates have slid below the call rate as well, especially for short term borrowing.

Indian monetary policy has quite rightly prioritized growth over inflation in the aftermath of the pandemic, with rate cuts as well as liquidity support. Former Reserve Bank of India governor D. Subbarao had pointed out that it is easier to enter the zone of expansionary monetary policy than to exit it, which could prove difficult. He had compared this to the chakravyuha that Abhimanyu entered in the Mahabharata.

Q.1. Critically examine the steps taken by RBI in its recent monetary policy responses undertaken to cope with pandemic in Indian context.

Q.2. Suggest at least three ways of exiting out of expansionary monetary policy.

Q.3. Elucidate your understanding of fiscal-monetary policy coordination? Why is it necessary for growth and macroeconomic stability in the economy?

Q.4. Has the government projected a liberal Fiscal deficit in FY22 or reverted to its conservative stance? Examine the stance taken in Union Budget 2021-22. Express your opinion with exact figures quoted from the Budget presented on 1st Feb, 2021 (Hint: "The fiscal deficit will be bigger than what is estimated earlier due to pandemic).

SECTION II (WEIGHTAGE 20)

INSTRUCTIONS: All questions are compulsory.

Q.5. An economy is characterized by the following equations-

Consumption Function = 50 + 0.5Y_d;
Investment = Rs. 350 Crores;
Tax = Rs. 60 Crores;
Government Expenditure = Rs. 200 Crores;
Exports = Rs. 90 Crores;
Imports M = 0.05 Y

Compute:
(a) The equilibrium level of income.
(b) The increase in government expenditure required to ensure that the economy reaches the full employment level of income of Rs. 1500 crores. **(2.5*2=5 Marks)**

Q.6. Based on the excerpt, answer the question that follow.

Gloomy weather: GDP growth rate grim
(Source:https://www.telegraphindia.com/opinion/gloomy-weather-gdp-growth-rate-grim/cid/1803374)

The current forecasts for the growth rates of gross domestic product are, expectedly, quite grim. The real GDP is estimated to contract by 7.7 per cent in 2020-21 compared to a positive growth of 4.2 per cent in 2019-20. The nominal GDP is also expected to shrink by 4.2 per cent this fiscal. The contraction in both real and nominal GDP is unprecedented in India's history. It has never happened before, even though the economy has experienced many shocks and slowdowns in the past 73 years. Part of this can certainly be attributed to the pandemic. However, the policy response to the pandemic in terms of a strict and sudden lockdown has much to do with the magnitude of the contraction.

Nominal GDP growth does a better job than real GDP growth in capturing business cyclical swings (phases of business cycles contraction, expansion etc.) Real growth is more likely to be smoothed." Do you agree with the statement? Explain your stand with reason **(5 Marks)**

Q.7. Read the following news dated January 7, 2021and answer the question.

A shrinking current account surplus could set rupee free
(Source:https://www.livemint.com/market/mark-to-market/a-shrinking-current-account-surplus-could-set-rupee-free-11610037118181.html)

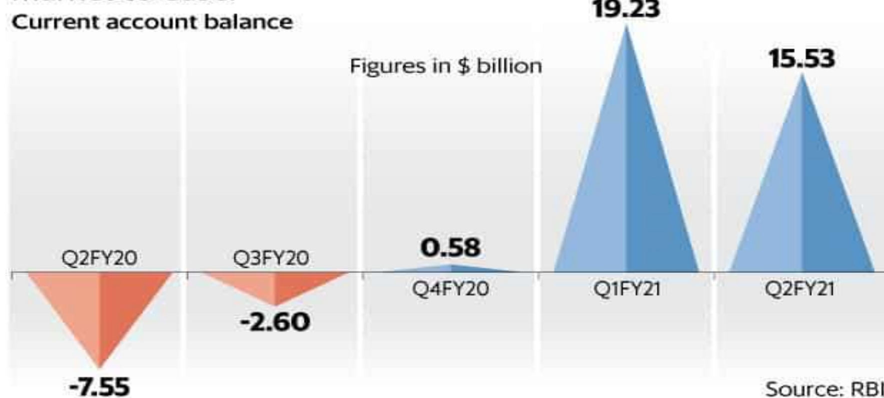
The Indian rupee depreciated by 2.6% in 2020 despite record dollar inflows coming into the country, thanks to the Reserve Bank of India's (RBI) relentless absorption of the inflows. The upside of this intervention has been a record pile of forex reserves that has served as a confidence booster for the markets. Indeed, RBI's interventions have been looked upon as prudent given that the economy was in no shape to absorb inflows during a recession. While there were many reasons for RBI's intervention, the main one was to filter out inflows during a recession.

Amid the pandemic, the collapse of domestic demand for imports led to a record current account surplus. The surge of dollar inflows only inflated the overall balance of payments surplus. A current account surplus driven by contraction in domestic demand for imports is not a good thing and when a surge in inflows coincides with this, it leads to distortions in asset prices. The central bank's interventions have gained strength in tandem with the growing surplus in the balance of payments. It is logical that RBI may end up easing back its intervention when this surplus too begins to wind down.

Economists at Barclays Securities (India) Pvt. Ltd believe that the odds for RBI to ease off on its interventions are increasing in the medium term. "In the absence of a persistent current account deficit, the RBI will have to continue to absorb excess foreign currency through intervention.

However, as the current account surplus reduces from 2020 levels, the marginal reserve accretion will likely slow as well, and will mostly come via capital inflows," they wrote in a note.

A recovery in the domestic economy has led to imports bouncing back. Of course, imports are still lower than what they were before the pandemic and exports have recovered more sharply. Given the recovery, the current account surplus narrowed to $15.53 billion in the September quarter from $19.23 billion in the June quarter of FY21. Economists expect this surplus to narrow further and fall into a deficit. However, a full-year deficit is unlikely until FY23, according to Barclays. Ergo, the RBI may not let go of the rupee but the exchange rate’s first steps towards greater freedom of movement has begun.



Elucidate the relationship between Current account surplus and exchange rate. Substantiate your answer with clues from the above excerpt. **(5 Marks)**

Q.8. The consumer price inflation (CPI) seems to be easing in India but the core inflation is still on a sticky wicket, a research report has said (Dec, 2020). Differentiate between CPI and other tools used for measuring Inflation. Suggest three ways through which higher core inflation can create problems for Indian economy. **(5 Marks)**