1. (*a*) Explain briefly the following concepts:

(*i*) Business fixed investment

(*ii*) Capital account. 3

(*b*) Assume people of the country expect inflation to be equal to 5 percent by the end of the 20th Century but in fact, prices rise by 20 percent over these ten decades. Describe how this unexpectedly high inflation rate would help or hurt the following : 5

(*i*) Firm that provides a fixed nominal pension when the worker retires.

(*ii*) A person taking out a mortgage in 1950 for 50 years.

2. (*a*) Suppose during the year the consumer price index rises from 150 to 162 and the nominal interest rate is 9 percent. What will be the real interest rate ? 3

(*b*) Using the quantity theory of money and the Fisher equation explain in detail how the rate of growth in money affects the nominal interest rate ? 5

(*c*) Consider a loanable funds market of an economy. The following equations describe the economy :

$$Y = C + G + I$$

$$Y = 3000$$

$$G = 1000$$

$$T = 1000$$

$$C = 250 + 0.5\ (Y - T)$$

$$I = 1000 - 50\ r$$

(i) Find the equilibrium rate of interest and national savings. 3

(ii) Now suppose the government reduces the taxes to 500. Compute by how much amount do the following change : disposable income, consumption, investment and national savings due to fall in the tax. 4

3. (*a*) Explain how the national wealth of a country can change ? 3

(*b*) What is a money multiplier ? Suppose an economy has a monetary base of \$ 20 million. Calculate money supply in the following situations :

(*i*) All the money is held as demand deposits and banks hold 20 percent of their deposits as reserves.

(*ii*) All the money is held as currency. 5

(*c*) (*i*) Define budget surplus. What does negative budget surplus means ? Explain using suitable diagram. 3

(*ii*) Explain the effect of increase in government purchase on budget surplus. 4