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Income Determination Revised Notes

Q24. Explain the role of the following in correcting deficient demand in an economy.

1. Open market operations

2. Bank rate

Ans.

1. Open market operations in correcting deficient demand in an economy – Open market operation refers to the sale and purchase of government and other approved securities by the central bank to the commercial bank and other financial institutions. When cash balance is to be raised in the economy, especially during situation of deficient demand, the central bank purchase more and more securities. This increases the cash holdings of the commercial banks thereby increasing loans and advances by them. Thus, leading to rise in aggregate demand.

2. Bank rate in correcting deficient demand in an economy – Bank rate is the rate at which the central bank lends money to the commercial banks. To control the situation of deficient demand, bank rate is decreased, due to this reduction of bank rate by central bank, commercial banks will fall the market rate of interest. This will lead to lower cost of borrowing from commercial banks to the consumers and investors. This increases demand for credit, thereby leading to more liquidity in the hands of the people. Consumption expenditure and investment expenditure are raised and aggregate demand (AD) will rise.

Q25. Draw a hypothetical propensity to consume curve from it. Draw this to

save the curve.

Ans. $APC = C/Y$, $APS = S/Y$

Propensity to save curve is drawn from propensity to consume curve.

When $Y=C$, then $APC = 1$, till that point APS is negative at point 'S'

When $Y>C$, there is a positive saving.

