GS SCORE
An Institute for Civil Services

PRELIMS 2025

INDIAN ECONOMY

PRACTICE TEST - 1

Economic Concepts & Policies

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Prelims PYQ+	Question Booklet

GENERAL STUDIES

PRACTICE TEST - 1

(Indian Economy: Economic Concepts and Policies)

Time Allowed: 40 Min. ***Maximum Marks: 50***

INSTRUCTIONS

1. IMMEDIATELY AFTER THE COMMENCEMENT OF THE EXAMINATION, YOU SHOULD CHECK THAT THIS TEST BOOKLET DOES *NOT* HAVE ANY UNPRINTED OR TORN OR MISSING PAGES OR ITEMS, ETC. IF SO, GET IT REPLACED BY A COMPLETE TEST BOOKLET.
2. **Please note that it is the candidate's responsibility to encode and fill in the Roll Number carefully without any omission or discrepancy at the appropriate places in the OMR Answer Sheet. Any omission/discrepancy will render the Answer Sheet liable for rejection.**
3. You have to enter your Roll Number on the test booklet in the Box provided alongside. ***DO NOT*** write anything else on the Test Booklet.
4. This Test Booklet contains ***25*** items (questions). Each item is printed in English. Each item comprises four responses (answers). You will select the response which you want to mark on the Answer Sheet. In case you feel that there is more than one correct response, mark the response which you consider the best. In any case, choose ***ONLY ONE*** response for each item.
5. You have to mark all your responses ***ONLY*** on the separate Answer Sheet provided. See directions in the Answer Sheet.
6. All items carry equal marks.
7. Before you proceed to mark in the Answer Sheet in response to various items in the Test Booklet, you have to fill in some particulars in the Answer Sheet as per instructions sent to you with your Admission Certificate.
8. After you have completed filling in all your responses on the Answer Sheet and the examination has concluded, you should hand over to the Invigilator ***only the Answer Sheet***. You are permitted to take away with you the Test Booklet.
9. Sheets for rough work are appended in the Test Booklet at the end.
10. **Penalty for wrong answers:**

    THERE WILL BE PENALTY FOR WRONG ANSWERS MARKED BY A CANDIDATE IN THE OBJECTIVE TYPE QUESTION PAPERS.

    (i) There are four alternatives for the answer to every question. For each question for which a wrong answer has been given by the candidate, **one-third** of the marks assigned to that question will be deducted as penalty.

    (ii) If a candidate gives more than one answer, it will be treated as a **wrong answer** even if one of the given answers happens to be correct and there will be same penalty as above to that question.

    (iii) If a question is left blank, i.e., no answer is given by the candidate, there will be **no** penalty for that question.

1. Consider the following statements about the Twin Deficit Hypothesis:

1. The hypothesis suggests a relationship between a country's fiscal deficit and current account deficit.
2. A rising fiscal deficit often leads to a higher current account deficit due to increased government borrowing.
3. Countries with a large domestic savings base are less vulnerable to twin deficits.

How many of the statements given above are correct?

(a) Only one

(b) Only two

(c) All three

(d) None

2. **Assertion (A):** A country with a high Gross Savings Rate does not necessarily have a high Gross Capital Formation.

Reason (R): The gap between domestic savings and capital formation is filled by net capital inflows, such as Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI).

(a) Both A and R are correct, and R is the correct explanation of A.

(b) Both A and R are correct, but R is not the correct explanation of A.

(c) A is correct, but R is incorrect.

(d) A is incorrect, but R is correct.

3. **Assertion (A):** Higher repo rates lead to lower inflation in an economy.

Reason (R): An increase in the repo rate reduces the supply of money in the economy, thereby curbing demand and controlling inflation.

(a) Both A and R are correct, and R is the correct explanation of A.

(b) Both A and R are correct, but R is not the correct explanation of A.

(c) A is correct, but R is incorrect.

(d) A is incorrect, but R is correct.

4. The term Fiscal Drag refers to:

(a) The slowdown in economic growth due to excessive government spending.

(b) The effect of inflation increasing government tax revenue while keeping tax rates unchanged.

(c) A fall in tax revenue due to higher tax rates discouraging production.

(d) The increase in public debt due to continued fiscal deficits.

5. Consider the following statements regarding the Impact of High Public Debt on an Economy:

1. High public debt increases the risk of inflationary pressure.
2. It reduces the effectiveness of fiscal policy during economic downturns.
3. A country with high public debt has a lower credit rating, making foreign borrowing costlier.

Which of the statements given above is/are correct?

(a) 1 and 2 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1, 2 and 3

6. **Assertion (A):** The Gross Fixed Capital Formation (GFCF) is an important indicator of economic growth.

Reason (R): GFCF represents net investment in fixed assets such as machinery, infrastructure, and buildings.

(a) Both A and R are correct, and R is the correct explanation of A.

(b) Both A and R are correct, but R is not the correct explanation of A.

(c) A is correct, but R is incorrect.

(d) A is incorrect, but R is correct.

7. If the Net Factor Income from Abroad (NFIA) is negative for a country, which of the following is true?

(a) GDP is greater than GNP.

(b) GNP is greater than GDP.

(c) Nominal GDP is greater than Real GDP.

(d) The country has a trade surplus.

8. Consider the following statements regarding inflation measurement in India:

1. The Wholesale Price Index (WPI) tracks inflation at the producer level, while the Consumer Price Index (CPI) tracks inflation at the retail level.
2. CPI excludes services, whereas WPI includes services.
3. RBI primarily uses CPI inflation as the nominal anchor for monetary policy in India.

Which of the statements given above is/are correct?

(a) 1 and 3 only
(b) 2 and 3 only
(c) 1, 2 and 3
(d) 1 and 2 only

9. Cost-push inflation occurs due to:

(a) An increase in aggregate demand in an economy.
(b) An increase in the cost of production inputs like wages and raw materials.
(c) A fall in overall money supply in the economy.
(d) A sudden appreciation of the currency leading to higher imports.

10. The monetary policy framework in India is primarily focused on:

(a) Maintaining foreign exchange stability
(b) Achieving high GDP growth
(c) Controlling inflation within a target band
(d) Reducing fiscal deficit

11. Consider the following instruments of monetary policy:

1. Repo rate
2. Reverse repo rate
3. Open Market Operations (OMO)
4. Cash Reserve Ratio (CRR)

Which of the above are quantitative tools of monetary policy?

(a) 1, 2, and 3 only
(b) 2, 3, and 4 only
(c) 1, 2, and 4 only
(d) 1, 2, 3, and 4

12. Consider the following statements regarding fiscal deficit:

1. Fiscal deficit represents the total borrowing requirements of the government.
2. A high fiscal deficit can lead to inflationary pressures in an economy.
3. Fiscal deficit = Total Revenue – Total Expenditure.

Which of the statements given above is/are correct?

(a) 1 and 2 only
(b) 2 and 3 only
(c) 1, 2, and 3
(d) 1 and 3 only

13. Consider the following statements about Real and Nominal GDP:

1. Nominal GDP is measured using current market prices, whereas Real GDP is adjusted for inflation.
2. If the inflation rate is high, Nominal GDP will be lower than Real GDP.
3. GDP deflator is used to convert Nominal GDP into Real GDP.

Which of the statements given above is/are correct?

(a) 1 and 2 only
(b) 1 and 3 only
(c) 2 and 3 only
(d) 1, 2 and 3

14. Consider the following statements regarding the concept of Phillips Curve:

1. It suggests an inverse relationship between inflation and unemployment in the short run.
2. In the long run, the Phillips Curve becomes vertical due to the absence of a trade-off between inflation and unemployment.
3. It forms the basis of the concept of stagflation.

Which of the statements given above is/are correct?

(a) 1 and 2 only
(b) 2 and 3 only
(c) 1 and 3 only
(d) 1, 2, and 3

15. **Assertion (A):** Higher levels of fiscal deficit in an economy can lead to crowding out of private investment.

Reason (R): A higher fiscal deficit often results in increased government borrowing, raising interest rates and reducing funds available for private investment.

(a) Both A and R are correct, and R is the correct explanation of A.

(b) Both A and R are correct, but R is not the correct explanation of A.

(c) A is correct, but R is incorrect.

(d) A is incorrect, but R is correct.

16. Consider the following statements regarding Core Inflation:

1. Core inflation measures the change in the price level of all goods and services in an economy, including food and fuel prices.
2. Core inflation is considered a better measure for monetary policy decisions compared to headline inflation.
3. In India, CPI-core inflation is the primary target for the Reserve Bank of India (RBI) while formulating monetary policy.

Which of the statements given above is/are correct?

(a) 1 and 2 only

(b) 2 and 3 only

(c) 1, 2, and 3

(d) 2 only

17. If the Reserve Bank of India reduces the Statutory Liquidity Ratio (SLR), which of the following will likely occur?

1. Banks will have more funds available for lending.
2. Liquidity in the banking system will increase.
3. The money supply in the economy will decrease.

Select the correct answer using the code given below:

(a) 1 and 2 only

(b) 2 and 3 only

(c) 1, 2, and 3

(d) 1 and 3 only

18. Consider the following statements regarding the MCLR (Marginal Cost of Funds-based Lending Rate) system:

1. It replaced the Base Rate system in 2016 to improve the transmission of monetary policy.
2. MCLR is calculated based on the cost of funds for banks, including repo rate and cost of deposits.
3. It is applicable to all types of loans, including housing and vehicle loans.

Which of the statements given above is/are correct?

(a) 1 and 2 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1, 2 and 3

19. Consider the following statements regarding the Laffer Curve in taxation:

1. It describes the relationship between tax rates and tax revenue.
2. Increasing tax rates beyond a certain point leads to higher tax revenue without economic consequences.
3. The curve suggests that at both extremely low and extremely high tax rates, tax revenue tends to be lower.

Which of the statements given above is/are correct?

(a) 1 and 3 only

(b) 2 and 3 only

(c) 1 and 2 only

(d) 1, 2 and 3

20. Which of the following actions by the government are likely to reduce the fiscal deficit?

1. Increasing direct taxes on high-income earners.
2. Reducing capital expenditure on infrastructure projects.
3. Issuing more government bonds in the open market.

Select the correct answer using the code given below:

(a) 1 and 2 only

(b) 2 and 3 only

(c) 1, 2 and 3

(d) 1 and 3 only

21. **Assertion (A):** Higher repo rates lead to lower inflation in an economy.

Reason (R): An increase in the repo rate reduces the supply of money in the economy, thereby curbing demand and controlling inflation.

(a) Both A and R are correct, and R is the correct explanation of A.

(b) Both A and R are correct, but R is not the correct explanation of A.

(c) A is correct, but R is incorrect.

(d) A is incorrect, but R is correct.

22. Consider the following statements regarding types of unemployment:

1. Disguised unemployment occurs when more workers are employed than required, leading to zero or negligible marginal productivity.
2. Cyclical unemployment is mainly associated with fluctuations in economic activity and is common in economies.
3. Structural unemployment arises due to a mismatch between workers' skills and the requirements of the job market.
4. Frictional unemployment is caused by short-term job transitions and is a normal part of an economy.

How many of the above statements are correct?

(a) Only one

(b) Only two

(c) Only three

(d) All four

23. Consider the following statements regarding Net National Product (NNP):

1. NNP is calculated by subtracting depreciation from Gross National Product (GNP).
2. NNP at market price accounts for indirect taxes and subsidies, whereas NNP at factor cost does not.
3. NNP always remains higher than GNP in an economy due to depreciation adjustments.

Which of the statements given above is/are correct?

(a) 1 and 2 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1, 2 and 3

24. Which of the following actions by the government will increase the fiscal deficit?

1. Providing direct cash transfers to farmers.
2. Reducing the corporate tax rate.
3. Increasing public sector wages without raising tax revenues.

Select the correct answer using the code given below:

(a) 1 and 2 only

(b) 2 and 3 only

(c) 1, 2 and 3

(d) 1 and 3 only

25. Consider the following statements regarding the implications of a Primary Deficit:

1. A declining primary deficit suggests that the government is moving towards fiscal discipline.
2. A rising primary deficit means the government is borrowing more for non-interest expenditure, increasing the overall debt burden.
3. If the primary deficit is negative, it means the government's revenue exceeds its total expenditure, including interest payments.

Which of the above statements are correct?

(a) 1 and 2 only

(b) 2 and 3 only

(c) 1 and 3 only

(d) 1, 2 and 3

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Space for Rough Work

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Prelims PYQ+	Answer Booklet

GENERAL STUDIES

PRACTICE TEST - 1

(Indian Economy: Economic Concepts and Policies)

Answer Key

Q. 1 (c)	Q. 6 (a)	Q. 11 (d)	Q. 16 (b)	Q. 21 (a)
Q. 2 (a)	Q. 7 (a)	Q. 12 (a)	Q. 17 (a)	Q. 22 (d)
Q. 3 (a)	Q. 8 (a)	Q. 13 (b)	Q. 18 (d)	Q. 23 (a)
Q. 4 (b)	Q. 9 (b)	Q. 14 (d)	Q. 19 (a)	Q. 24 (c)
Q. 5 (d)	Q. 10 (c)	Q. 15 (a)	Q. 20 (a)	Q. 25 (a)

1. Answer: (c) All three

Explanation:

- **Step 1: Understanding Statement 1**
- *"The hypothesis suggests a relationship between a country's fiscal deficit and current account deficit."*
    - The **Twin Deficit Hypothesis** states that **higher government borrowing (fiscal deficit) can lead to an increase in the current account deficit** because increased government spending raises overall demand, leading to higher imports.
    - Several studies, including those from the **IMF and World Bank**, support this link.
    - This statement is **correct**.
- **Step 2: Understanding Statement 2**
- *"A rising fiscal deficit often leads to a higher current account deficit due to increased government borrowing."*
    - When the government **borrows to finance its fiscal deficit**, it can lead to **higher interest rates and inflation**.
    - Increased government spending **raises aggregate demand**, which often results in **higher imports**, widening the current account deficit.
    - If the deficit is financed through **external borrowing**, it increases reliance on foreign capital, further exacerbating the current account deficit.
    - Empirical evidence shows that **developing countries often experience twin deficits when running high fiscal deficits**.
    - This statement is **correct**.
- **Step 3: Understanding Statement 3**
- *"Countries with a large domestic savings base are less vulnerable to twin deficits."*
    - A **high domestic savings rate** reduces dependence on external capital to finance fiscal deficits.
    - If a country's government borrows primarily from **domestic savers rather than foreign sources**, it does not lead to excessive capital outflows, thus preventing a rise in the current account deficit.
    - Countries like **Japan** have **large fiscal deficits but do not suffer from a high current account deficit** due to a strong domestic savings base.
    - This statement is **correct**.
- **Final Answer: Evaluating the Number of Correct Statements**
- All three statements are **correct**, making the right answer:
- **(c) All three.**

Key Takeaways

- **Twin Deficit Hypothesis** suggests that fiscal and current account deficits are interconnected.
- **Government borrowing and spending** can lead to higher demand for imports, increasing the current account deficit.
- **Countries with high domestic savings** can mitigate the impact of twin deficits by financing their deficits internally rather than relying on foreign capital.

2. Answer: (a) Both A and R are correct, and R is the correct explanation of A.

Explanation:

- **Step 1: Understanding the Assertion (A)**
- **"A country with a high Gross Savings Rate does not necessarily have a high Gross Capital Formation."**
    - **Gross Savings Rate** represents the total savings of households, businesses, and the government as a percentage of GDP.
    - **Gross Capital Formation (GCF)** refers to the total investment in physical assets like machinery, infrastructure, and buildings.
    - Even if a country has a high savings rate, it does not guarantee that all savings will be converted into productive investments due to factors such as:
        - **Low investor confidence** or policy uncertainty.
        - **Weak financial intermediation** (banks not lending effectively).
        - **Capital flight** (savings moving abroad).
        - **Underdeveloped financial markets** preventing savings from being channeled into investments.
    - Therefore, **Assertion (A) is correct**.

- **Step 2: Understanding the Reason (R)**
- **"The gap between domestic savings and capital formation is filled by net capital inflows, such as Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI)."**
  - If domestic savings are insufficient to meet investment needs, the country **relies on foreign capital inflows** (FDI, FPI, external commercial borrowings) to bridge the gap.
  - Countries with **investment deficits** (where GCF exceeds domestic savings) often attract FDI and FPI to sustain growth.
  - Emerging economies, such as **India and Brazil**, often use foreign capital to finance their infrastructure and industrial development.
  - This explanation aligns with the assertion, meaning **Reason (R) is also correct** and explains the assertion.
- **Step 3: Evaluating the Relationship Between A and R**
  - Since a **high savings rate does not automatically translate into high investment**, and **foreign capital inflows can bridge this gap**, the reason correctly explains the assertion.
- The correct answer is:
- **(a) Both A and R are correct, and R is the correct explanation of A.**

Key Takeaways

- **Savings and investment are not always equal**—a country may have high savings but low investment due to inefficiencies in financial markets.
- **Foreign capital inflows (FDI, FPI) help bridge the gap** when domestic savings are inadequate for investment needs.
- **Developing countries often rely on external capital** to supplement their domestic savings for higher capital formation.

3. Answer: (a) Both A and R are correct, and R is the correct explanation of A.

Explanation:

- **Step 1: Understanding the Assertion (A)**
- **"Higher repo rates lead to lower inflation in an economy."**
  - **Repo rate** is the rate at which the central bank lends money to commercial banks.
  - When the **repo rate increases**, borrowing costs for banks rise.
  - Banks **pass on higher borrowing costs to consumers and businesses** by increasing lending rates for loans.
  - Higher interest rates make borrowing **expensive**, reducing overall spending and investment.
  - Lower demand for goods and services reduces **inflationary pressures** in the economy.
- Since higher repo rates **discourage borrowing and spending, reducing inflation**, the **assertion is correct**.
- **Step 2: Understanding the Reason (R)**
- **"An increase in the repo rate reduces the supply of money in the economy, thereby curbing demand and controlling inflation."**
  - An increase in **repo rate reduces liquidity** because banks borrow less from the central bank.
  - Lower liquidity in the economy means **less money available for spending and investment**.
  - Reduced demand for goods and services helps **slow down inflation**.
  - This aligns with the **monetary policy transmission mechanism**, where **higher interest rates slow down economic activity and price rise**.
- Since the **reduction in money supply and demand directly leads to lower inflation**, the **reason is correct** and **explains the assertion**.
- **Step 3: Evaluating the Relationship Between A and R**
  - **Higher repo rates reduce money supply and demand, leading to lower inflation**, which means **R is the correct explanation of A**.
- The correct answer is:
- **(a) Both A and R are correct, and R is the correct explanation of A.**

Key Takeaways

- **Repo rate is a key monetary policy tool** used by the RBI to control inflation.
- **Increasing repo rates reduces liquidity, discourages borrowing, and curbs demand**, helping to lower inflation.

- **Monetary tightening (higher repo rates)** is effective in controlling demand-pull inflation, where excess demand drives up prices.
- **The repo rate transmission mechanism works through banks**, which pass on higher borrowing costs to consumers and businesses, reducing overall spending.

4. Answer: (b) The effect of inflation increasing government tax revenue while keeping tax rates unchanged.

Explanation:

- **Step 1: Understanding Fiscal Drag**
  - **Fiscal Drag** occurs when **inflation pushes taxpayers into higher tax brackets**, even though their real income (adjusted for inflation) has not increased.
  - This results in the government **collecting more tax revenue** without actively increasing tax rates.
  - The effect is a **reduction in disposable income**, which can slow down economic growth.
  - **Key characteristic**: It happens **when tax brackets are not adjusted for inflation**.
- **Step 2: Evaluating Each Option**
- **Option (a): The slowdown in economic growth due to excessive government spending.**
  - Excessive government spending may cause economic imbalances, but this is **not the definition of Fiscal Drag**.
  - This is more related to **crowding out effect** rather than Fiscal Drag.
  - **Incorrect**.
- **Option (b): The effect of inflation increasing government tax revenue while keeping tax rates unchanged.**
  - This correctly describes Fiscal Drag.
  - **As inflation increases nominal wages, more taxpayers fall into higher tax brackets**, increasing tax revenue.
  - This results in an **automatic increase in tax collection without a change in tax rates**.
  - **Correct answer**.
- **Option (c): A fall in tax revenue due to higher tax rates discouraging production.**
  - This refers to **the Laffer Curve**, which suggests that very high tax rates can reduce total revenue by discouraging production and investment.
  - **Not related to Fiscal Drag**.
  - **Incorrect**.
- **Option (d): The increase in public debt due to continued fiscal deficits.**
  - **Public debt increases when government expenditure exceeds revenue over time**.
  - Fiscal Drag is **not about debt but about unadjusted taxation leading to higher tax revenue**.
  - **Incorrect**.
- **Step 3: Confirming the Correct Answer**
- Since **Fiscal Drag** refers to **the rise in government tax revenue due to inflation pushing taxpayers into higher brackets without changing tax rates**, the correct answer is:
- **(b) The effect of inflation increasing government tax revenue while keeping tax rates unchanged.**

Key Takeaways

- **Fiscal Drag occurs when inflation causes higher tax collection without a tax rate increase**.
- **It reduces consumers' disposable income**, leading to lower spending and potentially slowing economic growth.
- **It is particularly relevant in progressive tax systems** where tax brackets are not adjusted for inflation.
- **Governments can reduce Fiscal Drag by adjusting tax brackets to account for inflation (indexation of tax slabs)**.

5. Answer: (d) 1, 2, and 3

Explanation:

- **Step 1: Evaluating Statement 1 – High public debt increases the risk of inflationary pressure.**
  - When a government **borrows heavily**, it often does so by:
    - Printing more money (**monetizing the debt**), leading to **higher money supply and inflation**.

  - Borrowing from domestic markets, which **increases demand for credit** and raises **interest rates**, contributing to cost-push inflation.
- High debt may lead to **higher fiscal deficits**, which can cause **demand-pull inflation** if excess spending continues.
- **Empirical evidence:** Countries with high debt, such as **Argentina and Venezuela**, have experienced extreme inflation.

- Since **high public debt can increase inflationary pressure, this statement is correct**.
- **Step 2: Evaluating Statement 2 – It reduces the effectiveness of fiscal policy during economic downturns.**
  - **Fiscal policy (government spending and taxation) is a key tool for economic stabilization.**
  - When debt is already high, the government **has limited room to increase spending during downturns** due to:
    - **Higher interest payments**, reducing funds available for productive spending.
    - **Investor concerns**, making further borrowing more expensive.
    - **Debt sustainability issues**, limiting expansionary fiscal policies.
  - Countries like **Greece** and **Italy** have struggled to use fiscal stimulus due to their already high debt burdens.
- Since **high debt limits a government's ability to use fiscal policy effectively, this statement is correct**.
- **Step 3: Evaluating Statement 3 – A country with high public debt has a lower credit rating, making foreign borrowing costlier.**
  - **Credit rating agencies (Moody's, S&P, Fitch)** assess a country's ability to repay debt.
  - **A high debt-to-GDP ratio signals financial risk**, leading to **downgrades in sovereign credit ratings**.
  - Lower credit ratings result in **higher interest rates on foreign borrowing**, making debt repayment more expensive.
  - **Example:** Sri Lanka's credit rating was downgraded due to unsustainable public debt, making international borrowing difficult.
- Since **higher public debt often leads to lower credit ratings and costlier borrowing, this statement is correct**.
- **Step 4: Final Answer Selection**
  - **All three statements (1, 2, and 3) are correct** based on economic principles and real-world examples.
- The correct answer is:
- **(d) 1, 2, and 3**.

Key Takeaways

- **High public debt can lead to inflation** if the government finances it through money printing or excessive borrowing.
- **It limits the effectiveness of fiscal policy** because governments have less flexibility to spend during downturns.
- **Countries with high debt face lower credit ratings**, leading to higher borrowing costs in international markets.
- **Debt sustainability is crucial** for maintaining economic stability and investor confidence.

6. Answer: (a) Both A and R are correct, and R is the correct explanation of A.

Explanation:

- **Step 1: Evaluating the Assertion (A) – GFCF is an important indicator of economic growth.**
  - **GFCF measures the net increase in fixed capital assets** such as buildings, machinery, equipment, and infrastructure in an economy.
  - A **higher GFCF indicates strong investment activity**, which leads to:
    - **Higher production capacity** in industries.
    - **Job creation** through infrastructure development.
    - **Boost in long-term economic productivity**.
  - **Developing economies, such as India and China, focus on increasing GFCF to sustain high GDP growth rates.**
  - Since **investment in fixed assets is a major driver of economic growth**, this assertion is **correct**.

- **Step 2: Evaluating the Reason (R) – GFCF represents net investment in fixed assets such as machinery, infrastructure, and buildings.**
  - **GFCF includes spending on physical assets** that contribute to long-term production capabilities.
  - It **excludes investment in financial assets or inventory stock** (which are not fixed capital).
  - Examples include:
    - **Government infrastructure projects (roads, bridges, airports).**
    - **Private sector investment in factories and equipment.**
  - **Since GFCF directly measures investments in productive assets, this reason is also correct**.
- **Step 3: Evaluating the Relationship Between A and R**
  - **Does investment in fixed assets (R) explain why GFCF is an important economic indicator (A)?**
  - Yes, because **higher investment in fixed capital leads to increased economic output and job creation, making GFCF a key growth indicator.**
  - Therefore, **R correctly explains A**.
- The correct answer is:
- **(a) Both A and R are correct, and R is the correct explanation of A.**

Key Takeaways

- Gross Fixed Capital Formation (GFCF) reflects investment in long-term physical assets.
- Higher GFCF leads to increased industrial production, employment, and GDP growth.
- It is an important macroeconomic indicator used by policymakers to assess economic expansion.
- Countries with high economic growth rates often have high levels of GFCF, as seen in China and India.

7. Answer: (a) GDP is greater than GNP.

Explanation:

- **Step 1: Understanding Key Economic Terms**
  - **Gross Domestic Product (GDP)**: Measures the total value of goods and services **produced within a country's territory**, including those by foreign-owned companies operating domestically.
  - **Gross National Product (GNP)**: Measures the total income earned by a country's **residents and businesses, including earnings from abroad**, but excludes income earned by foreigners within the country.
  - **Net Factor Income from Abroad (NFIA)**:
    - **NFIA = Income earned by residents abroad – Income earned by foreigners domestically**.
    - **If NFIA is positive**, GNP is **higher** than GDP (because residents earn more from abroad than foreigners earn domestically).
    - **If NFIA is negative**, GNP is **lower** than GDP (because foreigners earn more domestically than residents earn abroad).
- **Step 2: Evaluating the Given Condition (NFIA is Negative)**
  - **A negative NFIA means foreign companies and workers earn more inside the country than what domestic entities earn from abroad.**
  - This implies:
    - **GNP = GDP + NFIA** → Since **NFIA is negative**, GNP **<** GDP.
    - This happens when a country has **a high level of foreign investment or foreign-owned companies operating within its borders**.
- Since GDP is **greater** than GNP, **option (a) is correct**.
- **Step 3: Evaluating Other Options**
- **Option (b): GNP is greater than GDP.**
  - This is **incorrect** because NFIA is negative, meaning **GNP is lower than GDP**.
- **Option (c): Nominal GDP is greater than Real GDP.**
  - This is **unrelated to NFIA**.
  - **Nominal GDP** includes current prices, while **Real GDP** adjusts for inflation.
  - NFIA **does not affect the distinction between nominal and real GDP**.
  - **Incorrect option**.

- **Option (d): The country has a trade surplus.**
  - **A trade surplus refers to exports exceeding imports, which is unrelated to NFIA.**
  - A country can have **a trade surplus and still have negative NFIA** if foreign investments dominate.
  - **Incorrect option**.
- **Step 4: Confirming the Correct Answer**
  - Since **negative NFIA means GDP is greater than GNP**, the correct answer is:
- **(a) GDP is greater than GNP.**

Key Takeaways

- GDP measures domestic production, while GNP includes income from abroad.
- NFIA is negative when foreigners earn more in the country than domestic entities earn abroad.
- If NFIA is negative, GDP > GNP (as foreign earnings within the country reduce the net national income).
- This is common in economies with high foreign direct investment (FDI) and multinational companies.

8. Answer: (a) 1 and 3 only

Explanation:

- **Step 1: Evaluating Statement 1 – "The Wholesale Price Index (WPI) tracks inflation at the producer level, while the Consumer Price Index (CPI) tracks inflation at the retail level."**
  - **WPI measures inflation at the wholesale level**, meaning it reflects price changes before they reach consumers.
  - **CPI measures inflation at the consumer level**, meaning it tracks price changes in goods and services that consumers purchase directly.
  - WPI includes prices **before retail markups**, while CPI includes **final retail prices**.
- **This statement is correct.**
- **Step 2: Evaluating Statement 2 – "CPI excludes services, whereas WPI includes services."**
  - **CPI includes both goods and services**, as it measures the cost of living for consumers.
  - **WPI primarily tracks goods and does not include services**, as it focuses on bulk transactions at the wholesale level.
  - Since the statement claims that **CPI excludes services (which is incorrect) and WPI includes services (which is also incorrect)**, the statement is **incorrect**.
- **This statement is incorrect.**
- **Step 3: Evaluating Statement 3 – "RBI primarily uses CPI inflation as the nominal anchor for monetary policy in India."**
  - Prior to **2016**, the RBI monitored both WPI and CPI for inflation trends.
  - However, after adopting **inflation targeting** under the **Monetary Policy Framework Agreement (MPFA) in 2016**, the **Reserve Bank of India (RBI) primarily uses CPI-based inflation for monetary policy decisions**.
  - The inflation target is **4% (+/- 2%) based on CPI**.
- **This statement is correct.**
- **Step 4: Selecting the Correct Answer**
  - **Statements 1 and 3 are correct.**
  - **Statement 2 is incorrect.**
- The correct answer is:
- **(a) 1 and 3 only.**

Key Takeaways

- WPI measures inflation at the producer/wholesale level, while CPI measures inflation at the retail/consumer level.
- CPI includes services, while WPI does not.
- RBI uses CPI-based inflation as the primary indicator for monetary policy decisions.
- WPI is useful for assessing supply-side inflation, whereas CPI is more relevant for consumer cost-of-living analysis.

9. Answer: (b) An increase in the cost of production inputs like wages and raw materials.

Explanation:

- **Step 1: Understanding Cost-Push Inflation**
  - **Cost-push inflation occurs when production costs rise**, leading businesses to increase prices to maintain profit margins.

- The primary causes include:
  - **Higher wages** due to labor demands or policy changes (e.g., minimum wage hikes).
  - **Increased raw material costs** (e.g., oil price surges, supply chain disruptions).
  - **Higher import costs** due to currency depreciation.
  - **Tax increases** on businesses leading to price hikes.
- Cost-push inflation is **different from demand-pull inflation**, which is caused by excessive demand rather than supply-side constraints.
- **Step 2: Evaluating Each Option**
- **Option (a): An increase in aggregate demand in an economy.**
  - An increase in aggregate demand leads to **demand-pull inflation**, not cost-push inflation.
  - Demand-pull inflation occurs when **consumer and business spending exceeds supply capacity**, leading to price increases.
  - Since this describes a different type of inflation, it is **incorrect**.
- **Option (b): An increase in the cost of production inputs like wages and raw materials.**
  - This is the **core definition of cost-push inflation**.
  - When production costs rise, businesses **pass on the increased costs to consumers** through higher prices.
  - Examples include **fuel price hikes leading to transportation cost increases** and **rising steel prices affecting automobile production costs**.
  - Since this directly explains cost-push inflation, it is **correct**.
- **Option (c): A fall in overall money supply in the economy.**
  - A fall in money supply generally leads to **deflation or reduced inflation**, not cost-push inflation.
  - When money supply decreases, people have **less money to spend**, leading to lower demand rather than rising costs.
  - This does not match the definition of cost-push inflation, so it is **incorrect**.
- **Option (d): A sudden appreciation of the currency leading to higher imports.**
  - A currency appreciation makes imports **cheaper**, reducing costs rather than increasing them.
  - It could actually **reduce inflation** by lowering the prices of imported goods.
  - This does not contribute to cost-push inflation and is **incorrect**.
- **Step 3: Selecting the Correct Answer**
  - **The only option that accurately defines cost-push inflation is (b)**.
- The correct answer is:
- **(b) An increase in the cost of production inputs like wages and raw materials.**

Key Takeaways

- Cost-push inflation occurs when production costs rise, forcing businesses to increase prices.
- Major causes include higher wages, rising raw material prices, import costs, and increased business taxes.
- It is different from demand-pull inflation, which is driven by excessive demand rather than supply constraints.
- The correct answer focuses on the supply-side pressures that push prices upward.

10. Answer: (c) Controlling inflation within a target band

Explanation:

- **Step 1: Understanding the Monetary Policy Framework**
  - India's **monetary policy framework is based on inflation targeting**.
  - The **Monetary Policy Framework Agreement (MPFA)**, signed in **2016** between the **Government of India and RBI**, formally adopted **inflation targeting** as the primary objective of monetary policy.
  - Under this framework, the RBI aims to **maintain inflation within a target range of 4% (+/- 2%)** to ensure price stability while supporting economic growth.
  - The **Monetary Policy Committee (MPC)**, headed by the RBI Governor, is responsible for setting interest rates based on inflation trends.

- Since **controlling inflation within a target band is the key focus of monetary policy**, this aligns with **option (c)**.
- **Step 2: Evaluating Each Option**
- **Option (a): Maintaining foreign exchange stability**
  - While the RBI monitors exchange rates and intervenes when necessary, **foreign exchange stability is not the primary goal of monetary policy**.
  - India's monetary policy is **focused on domestic inflation**, while foreign exchange policy is managed separately.
  - **This option is incorrect**.
- **Option (b): Achieving high GDP growth**
  - While monetary policy **supports economic growth**, its primary role is **inflation control**.
  - **High GDP growth depends on multiple factors**, including fiscal policy, investment, and global economic conditions.
  - **Monetary policy alone cannot guarantee high GDP growth**.
  - **This option is incorrect**.
- **Option (c): Controlling inflation within a target band**
  - This directly reflects **India's monetary policy framework**.
  - The RBI's primary goal is to **maintain inflation within the 2%-6% range**.
  - The repo rate and other monetary tools are adjusted to **keep inflation in check while balancing economic growth**.
  - **This option is correct**.
- **Option (d): Reducing fiscal deficit**
  - **Fiscal deficit management falls under the government's fiscal policy**, not monetary policy.
  - The RBI may influence borrowing costs through interest rate changes, but **fiscal policy decisions (like taxation and public spending) are taken by the government**.
  - **This option is incorrect**.
- **Step 3: Selecting the Correct Answer**
  - The **primary focus of India's monetary policy is inflation control within a target range**.
- The correct answer is:
- **(c) Controlling inflation within a target band**.

Key Takeaways

- India's monetary policy framework prioritizes inflation control within a target range of 4% (+/-2%).
- The Monetary Policy Committee (MPC) sets interest rates primarily to maintain price stability.
- While monetary policy influences economic growth and exchange rates, its main objective is inflation targeting.
- Fiscal deficit management falls under fiscal policy, not monetary policy.

11. Answer: (d) 1, 2, 3, and 4

Explanation:

- **Step 1: Understanding Monetary Policy Tools**
  - **Monetary policy tools** are classified into:
    - **Quantitative tools** – Control **the overall money supply** in the economy.
    - **Qualitative tools** – Influence **specific sectors** by altering lending policies.
- **Quantitative tools impact the entire economy**, while qualitative tools are selective. The given options must be examined to confirm whether they are quantitative tools.
- **Step 2: Evaluating Each Option**
- **Repo Rate (Statement 1)**
  - **Definition:** The interest rate at which the **RBI lends to commercial banks** for short-term liquidity needs.
  - **Effect: Higher repo rates reduce money supply (restrictive policy)**, while **lower repo rates increase liquidity (expansionary policy)**.
  - **Category:** A **quantitative tool**, as it affects overall liquidity.
- **This statement is correct.**
- **Reverse Repo Rate (Statement 2)**
  - **Definition:** The interest rate at which the **RBI borrows from commercial banks** to absorb excess liquidity.

- **Effect: A higher reverse repo rate encourages banks to park surplus funds with RBI, reducing money supply.**
- **Category:** A **quantitative tool**, as it impacts money circulation.

- **This statement is correct.**
- **Open Market Operations (OMO) (Statement 3)**
  - **Definition:** RBI **buys or sells government securities** to regulate liquidity in the banking system.
  - **Effect:**
    - **Buying securities injects liquidity (expansionary policy).**
    - **Selling securities absorbs liquidity (restrictive policy).**
  - **Category:** A **quantitative tool**, as it impacts the money supply.
- **This statement is correct.**
- **Cash Reserve Ratio (CRR) (Statement 4)**
  - **Definition:** The percentage of a bank's **total deposits that must be kept as reserves with the RBI**.
  - **Effect:**
    - **Higher CRR reduces lending capacity, lowering money supply.**
    - **Lower CRR increases bank lending, boosting liquidity.**
  - **Category:** A **quantitative tool**, as it affects overall money supply.
- **This statement is correct.**
- **Step 3: Confirming the Correct Answer**
  - **All four options (Repo Rate, Reverse Repo Rate, Open Market Operations, CRR) are quantitative tools** as they influence the **total money supply in the economy**.
- The correct answer is:
- **(d) 1, 2, 3, and 4**.

Key Takeaways

- **Quantitative tools regulate the overall money supply in the economy**, whereas qualitative tools target specific sectors.
- **Repo rate, reverse repo rate, OMO, and CRR are all quantitative tools.**
- **These tools are used by the RBI to control inflation, ensure economic stability, and manage liquidity.**
- **CRR directly influences banks' lending capacity, while OMO affects liquidity through securities transactions.**

12. Answer: (a) 1 and 2 only

Explanation:

- **Step 1: Evaluating Statement 1 – "Fiscal deficit represents the total borrowing requirements of the government."**
  - **Fiscal deficit is the shortfall between the government's total expenditure and its total revenue (excluding borrowings).**
  - When the government **spends more than it earns**, it **borrows money to finance the deficit**.
  - The fiscal deficit represents **how much the government needs to borrow to meet its spending commitments**.
  - Since fiscal deficit directly indicates the **government's borrowing requirements**, this statement is **correct**.
- **Step 2: Evaluating Statement 2 – "A high fiscal deficit can lead to inflationary pressures in an economy."**
  - A **high fiscal deficit increases government borrowing**, leading to **higher public spending**.
  - If the economy is already operating at full capacity, increased government expenditure can **fuel demand-pull inflation**.
  - If the fiscal deficit is **monetized (financed by printing money)**, it leads to **excess liquidity in the economy**, further increasing inflation.
  - Empirical evidence from **developing economies, such as India, Argentina, and Brazil**, shows that high fiscal deficits can lead to **macroeconomic instability**.
  - Since a high fiscal deficit can contribute to inflation, this statement is **correct**.
- **Step 3: Evaluating Statement 3 – "Fiscal deficit = Total Revenue – Total Expenditure."**
  - The correct formula for fiscal deficit is: **Fiscal Deficit = Total Expenditure – Total Revenue (excluding borrowings).**

- The statement **incorrectly reverses the formula**, which should reflect the shortfall in revenue rather than a simple difference.
- Since this is a **misrepresentation of the formula**, the statement is **incorrect**.

- **Step 4: Selecting the Correct Answer**
  - **Statements 1 and 2 are correct.**
  - **Statement 3 is incorrect due to the wrong formula.**
- The correct answer is:
- **(a) 1 and 2 only.**

Key Takeaways

- Fiscal deficit represents the total borrowing needs of the government to cover its spending gap.
- A high fiscal deficit can lead to inflation, especially if financed by money printing or excessive borrowing.
- The correct formula for fiscal deficit is Total Expenditure – Total Revenue (excluding borrowings).
- Sustained high fiscal deficits can affect macroeconomic stability, interest rates, and sovereign credit ratings.

13. Answer: (b) 1 and 3 only

Explanation:

- **Step 1: Evaluating Statement 1 – "Nominal GDP is measured using current market prices, whereas Real GDP is adjusted for inflation."**
  - **Nominal GDP** is calculated using **current market prices**, meaning it includes the effects of **inflation or deflation**.
  - **Real GDP** is adjusted for inflation, meaning it reflects **the actual production of goods and services at constant prices** (using a base year for comparison).
  - Since **Real GDP removes the effect of price changes**, it provides a more accurate measure of economic growth.
  - **This statement correctly defines both concepts and is correct.**
- **Step 2: Evaluating Statement 2 – "If the inflation rate is high, Nominal GDP will be lower than Real GDP."**
  - **Inflation increases Nominal GDP because Nominal GDP includes price level changes.**
  - If inflation is high, **Nominal GDP will be higher than Real GDP**, not lower.
  - In reality, **Real GDP will be lower than Nominal GDP in an inflationary environment**, since inflation-adjusted GDP removes the impact of rising prices.
  - **This statement is incorrect.**
- **Step 3: Evaluating Statement 3 – "GDP deflator is used to convert Nominal GDP into Real GDP."**
  - The **GDP deflator** is an index that measures **the impact of inflation on GDP**.
  - It is calculated using the formula: **GDP Deflator = (Nominal GDP / Real GDP) × 100**
  - Using the GDP deflator, Nominal GDP can be adjusted to remove the effects of inflation and obtain **Real GDP**.
  - **This statement is correct.**
- **Step 4: Selecting the Correct Answer**
  - **Statement 1 is correct** (Nominal GDP uses current prices, Real GDP is inflation-adjusted).
  - **Statement 2 is incorrect** (Nominal GDP is higher than Real GDP in an inflationary scenario).
  - **Statement 3 is correct** (GDP deflator is used to calculate Real GDP from Nominal GDP).
- The correct answer is:
- **(b) 1 and 3 only.**

Key Takeaways

- Nominal GDP includes inflation, while Real GDP is adjusted for inflation.
- If inflation is high, Nominal GDP will be higher than Real GDP, not lower.
- GDP deflator helps measure inflation's impact on GDP and is used to calculate Real GDP from Nominal GDP.
- Real GDP is the better measure of actual economic growth, as it removes the effect of price changes.

14. Answer: (d) 1, 2, and 3

Explanation:

- **Step 1: Evaluating Statement 1 – "It suggests an inverse relationship between inflation and unemployment in the short run."**

- The **Phillips Curve**, proposed by **A.W. Phillips in 1958**, initially demonstrated a **short-run inverse relationship** between **inflation and unemployment**.
- When **inflation is high**, unemployment tends to be **low** because rising prices encourage businesses to hire more workers.
- Conversely, when **inflation is low**, unemployment tends to be **higher** due to reduced economic activity.
- This relationship was observed in several economies, making it a fundamental concept in macroeconomic policy.
- **This statement is correct.**

- **Step 2: Evaluating Statement 2 – "In the long run, the Phillips Curve becomes vertical due to the absence of a trade-off between inflation and unemployment."**
  - **Milton Friedman and Edmund Phelps (1960s)** challenged the original Phillips Curve, arguing that in the **long run**, there is **no trade-off between inflation and unemployment**.
  - In the long run, **wage expectations adjust** to inflation, causing the economy to return to its **natural rate of unemployment (NAIRU - Non-Accelerating Inflation Rate of Unemployment)**.
  - This results in a **vertical Phillips Curve**, meaning that **inflation has no long-term effect on unemployment**.
  - This theory was later supported by empirical evidence, especially during the 1970s oil shocks.
  - **This statement is correct.**

- **Step 3: Evaluating Statement 3 – "It forms the basis of the concept of stagflation."**
  - **Stagflation (1970s)** refers to a situation where an economy experiences **high inflation and high unemployment simultaneously**.
  - The **traditional Phillips Curve could not explain stagflation**, as it predicted that **high unemployment should be associated with low inflation, not both rising together**.
  - This breakdown of the Phillips Curve led to **the development of new macroeconomic models**, including **supply-side economics**.
  - **Stagflation played a key role in the rejection of the simple Phillips Curve relationship**, proving that inflation and unemployment can rise together.
  - **This statement is correct.**

- **Step 4: Selecting the Correct Answer**
  - **Statement 1 is correct** (Inverse relationship between inflation and unemployment in the short run).
  - **Statement 2 is correct** (Phillips Curve becomes vertical in the long run).
  - **Statement 3 is correct** (Stagflation challenged the Phillips Curve, influencing economic theory).
- The correct answer is:
- **(d) 1, 2, and 3.**

Key Takeaways

- The Short-Run Phillips Curve shows an inverse relationship between inflation and unemployment.
- The Long-Run Phillips Curve is vertical, meaning inflation has no effect on unemployment.
- Stagflation (1970s) challenged the Phillips Curve, leading to new economic models.
- Modern economic theories incorporate expectations and supply-side factors to explain inflation and unemployment dynamics.

15. Answer: (a) Both A and R are correct, and R is the correct explanation of A.

Explanation:

- **Step 1: Evaluating the Assertion (A) – "Higher levels of fiscal deficit in an economy can lead to crowding out of private investment."**
  - **Fiscal deficit** occurs when **government expenditure exceeds its revenue**, requiring the government to **borrow funds** to finance the shortfall.
  - When the government borrows **excessively from the financial markets**, it competes with the private sector for available credit.
  - This **reduces the pool of loanable funds** available for businesses and individuals.
  - As a result, **private investment declines**, leading to the **crowding-out effect**.

- Since this describes a well-established economic phenomenon, **the assertion is correct**.

- **Step 2: Evaluating the Reason (R) – "A higher fiscal deficit often results in increased government borrowing, raising interest rates and reducing funds available for private investment."**
  - When the government **borrows more**, the **demand for credit increases**, leading to a rise in **interest rates** (cost of borrowing).
  - Higher interest rates **discourage private firms** from taking loans for investment, as borrowing becomes more expensive.
  - This reduction in private investment is known as the **crowding-out effect**.
  - **Empirical evidence**: In economies with persistent fiscal deficits (e.g., **India, USA, Greece**), periods of high public borrowing have led to **higher interest rates**, reducing private investment.
  - Since **government borrowing directly influences interest rates and credit availability, this reason is correct**.
- **Step 3: Evaluating the Relationship Between A and R**
  - The **reason correctly explains the assertion** because **higher fiscal deficits lead to increased government borrowing, which in turn raises interest rates, reducing private investment**.
- Since **both statements are correct and R explains A**, the correct answer is:
- **(a) Both A and R are correct, and R is the correct explanation of A.**

Key Takeaways

- **Crowding-out effect** occurs when high government borrowing **reduces the availability of funds for private sector investment**.
- **Fiscal deficit leads to increased demand for credit**, which **raises interest rates**, making borrowing costlier for businesses and individuals.
- **Higher interest rates discourage private investment**, slowing down economic growth in the long run.
- **The relationship between fiscal deficit, borrowing, and interest rates is well-established in macroeconomic theory**.

16. Answer: (b) 2 and 3 only

Explanation:

- **Step 1: Evaluating Statement 1 – "Core inflation measures the change in the price level of all goods and services in an economy, including food and fuel prices."**
  - **Core inflation excludes food and fuel prices** because these items are highly volatile due to **seasonal factors, supply shocks, and international price fluctuations**.
  - **Headline inflation** includes **all goods and services**, including food and fuel, while **Core inflation focuses on more stable components**.
  - Since **this statement incorrectly states that core inflation includes food and fuel**, it is **incorrect**.
- **Statement 1 is incorrect.**
- **Step 2: Evaluating Statement 2 – "Core inflation is considered a better measure for monetary policy decisions compared to headline inflation."**
  - **Core inflation provides a clearer picture of long-term inflation trends** by filtering out temporary price fluctuations.
  - **Food and fuel prices are volatile**, often driven by **external shocks** (e.g., weather conditions, geopolitical events, oil price changes).
  - Since monetary policy works **with a lag**, central banks focus on core inflation to make policy adjustments.
  - **RBI and other central banks** prefer core inflation as a measure for policy decisions because it reflects **underlying inflationary trends** rather than temporary fluctuations.
- **Statement 2 is correct.**
- **Step 3: Evaluating Statement 3 – "In India, CPI-core inflation is the primary target for the Reserve Bank of India (RBI) while formulating monetary policy."**
  - **RBI uses Consumer Price Index (CPI)-based inflation as the primary target for monetary policy.**
  - **While headline CPI is considered**, core CPI (which excludes food and fuel) is **closely monitored** to assess underlying inflation trends.

- RBI's **Monetary Policy Framework Agreement (2016)** mandates an **inflation target of 4% (+/-2%) based on CPI**, and core inflation plays a crucial role in decision-making.

- **Statement 3 is correct.**
- **Step 4: Selecting the Correct Answer**
  - **Statement 1 is incorrect** (core inflation excludes food and fuel).
  - **Statements 2 and 3 are correct** (core inflation is better for monetary policy, and RBI considers CPI-core in policy formulation).
- The correct answer is:
- **(b) 2 and 3 only.**

Key Takeaways

- **Core inflation excludes food and fuel prices** because they are volatile and influenced by temporary supply shocks.
- **Monetary policy focuses on core inflation** as it provides a better measure of long-term price stability.
- **RBI primarily targets CPI inflation**, but core inflation is crucial for assessing policy adjustments.
- Headline inflation reflects all price changes, while core inflation filters out short-term volatility.

17. Answer: (a) 1 and 2 only

Explanation:

- **Step 1: Understanding Statutory Liquidity Ratio (SLR)**
  - **SLR is the percentage of a bank's net demand and time liabilities (NDTL) that must be maintained in the form of liquid assets (cash, gold, or government securities).**
  - The **RBI mandates SLR to ensure liquidity and financial stability in the banking system**.
  - A **reduction in SLR means banks have to keep fewer reserves, freeing up more funds for lending**.
- **Step 2: Evaluating Each Statement**
- **Statement 1: Banks will have more funds available for lending.**
  - When the **RBI reduces SLR**, banks need to hold **fewer government securities or reserves**, meaning **they can lend more to businesses and individuals**.
  - This directly **boosts credit availability**, helping stimulate economic activity.
  - **This statement is correct.**
- **Statement 1 is correct.**
- **Statement 2: Liquidity in the banking system will increase.**
  - Since banks **hold fewer reserves in government securities**, **more money is available in the financial system**, increasing overall **liquidity**.
  - With increased liquidity, **interest rates may decrease**, encouraging borrowing and investment.
  - **This statement is correct.**
- **Statement 2 is correct.**
- **Statement 3: The money supply in the economy will decrease.**
  - A **reduction in SLR increases liquidity**, making **more money available for lending**, which **expands the money supply**.
  - **This contradicts the statement, as money supply will increase, not decrease**.
  - **This statement is incorrect.**
- **Statement 3 is incorrect.**
- **Step 3: Selecting the Correct Answer**
  - **Statements 1 and 2 are correct** (More funds available for lending, increased liquidity).
  - **Statement 3 is incorrect** (Money supply increases, not decreases).
- The correct answer is:
- **(a) 1 and 2 only.**

Key Takeaways

- A reduction in SLR frees up bank funds for lending, increasing liquidity in the banking system.
- More liquidity means more credit flow to businesses and individuals, boosting economic activity.
- Money supply does not decrease; instead, it increases as banks lend more.
- SLR is a key monetary tool used by RBI to control liquidity and credit flow in the economy.

18. Answer: (d) 1, 2, and 3

Explanation:

- **Step 1: Understanding the Concept of MCLR**

- **MCLR (Marginal Cost of Funds-based Lending Rate)** is the minimum interest rate at which banks can lend money.
- **Introduced in April 2016**, it replaced the **Base Rate system** to improve **monetary policy transmission** by ensuring that changes in RBI's policy rates are reflected in lending rates.
- It aims to make **interest rate transmission more transparent and responsive** to changes in the cost of funds for banks.

- **Step 2: Evaluating Each Statement**
- **Statement 1: MCLR replaced the Base Rate system in 2016 to improve the transmission of monetary policy.**
- **Correct.**
  - Before 2016, banks followed the **Base Rate** system, which was slow in responding to changes in the RBI's repo rate.
  - The **MCLR system was introduced on April 1, 2016**, to ensure **better monetary policy transmission**.
  - Under MCLR, banks adjust their lending rates **faster** in response to RBI's repo rate changes.
- **Statement 2: MCLR is calculated based on the cost of funds for banks, including repo rate and cost of deposits.**
- **Correct.**
  - **MCLR is determined based on the marginal cost of funds**, which includes:
    - **Repo rate** (borrowing cost from RBI).
    - **Cost of deposits** (interest paid on public deposits).
    - **Operating expenses** (bank's internal costs).
    - **Tenor premium** (higher rates for long-term loans due to risk).
- **Statement 3: MCLR is applicable to all types of loans, including housing and vehicle loans.**
- **Correct.**
  - **Initially, MCLR was applicable to most retail loans**, including **housing loans, car loans, personal loans, and business loans**.
  - However, in **October 2019**, RBI introduced the **External Benchmark Lending Rate (EBLR)** system, which applies **only to new floating rate loans**.
  - Despite the **EBLR system**, MCLR **still applies to fixed-rate loans and older floating-rate loans**.
- **Step 3: Selecting the Correct Answer**
  - **Statement 1 is correct** → MCLR replaced the Base Rate system in **2016**.
  - **Statement 2 is correct** → MCLR is based on **repo rate, cost of deposits, and operating costs**.
  - **Statement 3 is correct → MCLR applies to various loan types, including housing and vehicle loans**.
- **Since all three statements are correct, the correct answer is:**
- **(d) 1, 2, and 3**

Key Takeaways

- **MCLR (Marginal Cost of Funds-based Lending Rate) was introduced in 2016** to improve **monetary policy transmission** by linking lending rates to the cost of funds for banks.
- **MCLR is based on repo rate, cost of deposits, operational costs, and tenor premium.**
- **It applies to various types of loans, including housing and vehicle loans.**
- **The External Benchmark Lending Rate (EBLR) introduced in 2019 now applies to new floating rate loans, while MCLR still affects fixed-rate and older floating loans.**

19. Answer: (a) 1 and 3 only

Explanation:

- **Step 1: Evaluating Statement 1 – "It describes the relationship between tax rates and tax revenue."**
  - The **Laffer Curve** is a graphical representation showing that **tax revenue does not always increase with higher tax rates**.
  - At **low tax rates**, increasing taxes can increase government revenue.
  - However, at **very high tax rates**, taxation discourages work, investment, and economic activity, leading to lower tax revenue.

  - This correctly describes the function of the Laffer Curve.
- **Statement 1 is correct.**
- **Step 2: Evaluating Statement 2 – "Increasing tax rates beyond a certain point leads to higher tax revenue without economic consequences."**
  - **This is incorrect because high tax rates have economic consequences.**
  - If tax rates are too high:
    - **People work less or avoid declaring income** (leading to tax evasion).
    - **Businesses relocate to low-tax regions** (capital flight).
    - **Investment and productivity decline**, leading to lower GDP growth.
  - The Laffer Curve suggests that after an **optimal tax rate**, further tax increases **reduce tax revenue** instead of increasing it.
  - **This statement contradicts the core principle of the Laffer Curve and is incorrect.**
- **Statement 2 is incorrect.**
- **Step 3: Evaluating Statement 3 – "The curve suggests that at both extremely low and extremely high tax rates, tax revenue tends to be lower."**
  - The **Laffer Curve is shaped like an inverted U**, meaning:
    - **At very low tax rates**, the government collects **little revenue** because the tax base is too small.
    - **At very high tax rates**, revenue also declines because economic activity is discouraged.
    - **Maximum revenue is achieved at an optimal tax rate** somewhere in the middle.
  - This aligns perfectly with the Laffer Curve concept.
- **Statement 3 is correct.**
- **Step 4: Selecting the Correct Answer**
  - **Statement 1 is correct** (Laffer Curve explains the relationship between tax rates and revenue).
  - **Statement 2 is incorrect** (higher taxes do have economic consequences).
  - **Statement 3 is correct** (extreme tax rates reduce revenue).
- The correct answer is:
- **(a) 1 and 3 only.**

Key Takeaways

- The Laffer Curve suggests that beyond an optimal tax rate, increasing taxes leads to lower revenue.
- Excessive taxation discourages work, investment, and economic activity, reducing the tax base.
- At both extremely low and extremely high tax rates, government revenue is lower.
- Tax policy must balance revenue collection with economic incentives to ensure sustainable growth.

20. Answer: (a) 1 and 2 only

Explanation:

- **Step 1: Understanding Fiscal Deficit**
  - **Fiscal deficit** represents the **gap between total government expenditure and total revenue (excluding borrowings)**.
  - **A high fiscal deficit means the government is spending more than it earns**, requiring borrowing to cover the shortfall.
  - **To reduce fiscal deficit**, the government must either **increase revenue** (through taxation or other sources) or **reduce expenditure**.
- **Step 2: Evaluating Each Option**
- **Statement 1: Increasing direct taxes on high-income earners**
  - **Higher direct taxes (e.g., income tax, corporate tax) increase government revenue**, helping to reduce the fiscal deficit.
  - **Progressive taxation** ensures that high-income groups contribute more, reducing the need for borrowing.
  - **Example:** A government increasing **income tax on the wealthy** generates additional revenue.
  - **This measure directly reduces the fiscal deficit**.
- **Statement 1 is correct.**
- **Statement 2: Reducing capital expenditure on infrastructure projects**
  - **Capital expenditure includes spending on long-term assets like roads, railways, and power plants.**

- While reducing capital expenditure helps **cut government spending in the short term**, it may slow down economic growth in the long run.
- Since fiscal deficit is calculated as **Expenditure – Revenue**, reducing capital expenditure lowers the deficit.
- **Example:** The government postponing or reducing funding for a large infrastructure project to control spending.
- **This measure directly reduces the fiscal deficit.**

- **Statement 2 is correct.**
- **Statement 3: Issuing more government bonds in the open market**
  - **Government bonds are a form of borrowing, not revenue generation.**
  - Issuing more bonds **does not reduce the fiscal deficit**; it **finances the deficit** by increasing government debt.
  - **Example:** If the government issues bonds to raise money, it still has to **repay the debt with interest** in the future, which can increase long-term liabilities.
  - **This measure does not reduce the fiscal deficit.**
- **Statement 3 is incorrect.**
- **Step 3: Selecting the Correct Answer**
  - **Statements 1 and 2 are correct** (Increasing direct taxes and reducing capital expenditure help reduce the fiscal deficit).
  - **Statement 3 is incorrect** (Issuing government bonds does not reduce the deficit; it only finances it).
- The correct answer is:
- **(a) 1 and 2 only.**

Key Takeaways

- Fiscal deficit can be reduced by increasing government revenue (higher taxation) or reducing expenditure (cutting spending).
- Increasing direct taxes on high-income earners raises government revenue, reducing fiscal deficit.
- Reducing capital expenditure lowers government spending, reducing the deficit in the short term.
- Issuing more government bonds does not reduce the deficit but increases government debt.

21. Answer: (a) Both A and R are correct, and R is the correct explanation of A.

Explanation:

- **Step 1: Evaluating the Assertion (A) – "Higher repo rates lead to lower inflation in an economy."**
  - **The repo rate is the interest rate at which the Reserve Bank of India (RBI) lends to commercial banks.**
  - **When the RBI increases the repo rate, borrowing becomes more expensive for banks**, leading to:
    - Higher lending rates for businesses and consumers.
    - Reduced borrowing and spending in the economy.
    - Lower demand for goods and services.
- **Since inflation is driven by high demand and excess liquidity, reducing money supply through higher repo rates helps control inflation.**
- **This assertion is correct.**
- **Step 2: Evaluating the Reason (R) – "An increase in the repo rate reduces the supply of money in the economy, thereby curbing demand and controlling inflation."**
  - **When the repo rate rises, banks borrow less from the RBI.**
  - **With limited access to cheaper credit, banks pass on higher rates to consumers and businesses.**
  - This leads to:
    - Lower consumer spending on goods, housing, and services.
    - Reduced investment by businesses due to higher borrowing costs.
    - Slower economic activity, leading to lower price pressures.
- **Since inflation is demand-driven, reducing demand through tighter monetary policy helps control inflation.**
- **This reason is correct.**
- **Step 3: Evaluating the Relationship Between A and R**
  - **Does R explain A?**

- **Yes**, because **higher repo rates reduce money supply and borrowing, which in turn lowers inflation**.
- **Since the reason directly explains the assertion, the correct answer is:**
- **(a) Both A and R are correct, and R is the correct explanation of A.**

Key Takeaways

- The repo rate is a key monetary policy tool used by RBI to regulate inflation.
- Higher repo rates make borrowing more expensive, reducing money supply and demand.
- Lower demand leads to reduced inflationary pressures in the economy.
- This mechanism is a fundamental principle of inflation targeting under monetary policy frameworks.

22. Answer: (d) All four

Explanation:

- **Step 1: Understanding the Concepts of Unemployment**
  - **Disguised Unemployment**
    - Occurs when **more workers are employed than required**, leading to **zero or negligible marginal productivity**.
    - **Common in agriculture-based economies** where laborers contribute little to overall output.
    - **Example:** In a family farm, if five people are working, but only two are required to produce the same yield, the remaining three are **disguisedly unemployed**.
    - **Statement 1 is correct.**
  - **Cyclical Unemployment**
    - Caused by **economic downturns and recessions**, leading to **job losses due to reduced demand for goods and services**.
    - More prevalent in **capitalist and industrialized economies** where economic cycles (boom and recession) significantly impact employment.
    - **Example:** The **2008 Global Financial Crisis** led to mass layoffs across industries due to reduced economic activity.
    - The question originally stated **"common in economies"** (instead of "capitalist economies"), but since all economies experience fluctuations, the statement remains **broadly correct**.
    - **Statement 2 is correct.**
  - **Structural Unemployment**
    - Occurs when **workers' skills do not match job market demands** due to technological advancements, automation, or industry shifts.
    - **Long-term unemployment problem** as workers must **reskill or retrain**.
    - **Example:** Weavers losing jobs due to the rise of mechanized textile mills, or coal miners becoming unemployed as the world shifts to renewable energy.
    - **Statement 3 is correct.**
  - **Frictional Unemployment**
    - **Short-term unemployment** caused by workers **switching jobs, relocating, or transitioning between careers**.
    - Considered **a normal part of the economy** and **not a sign of distress**.
    - **Example:** A software engineer who quits their job to find a better opportunity remains **frictionally unemployed** until re-employed.
    - **Statement 4 is correct.**
- **Step 2: Analysing the Answer Choices**
  - **Statement 1 is correct** → Disguised unemployment involves more workers than needed.
  - **Statement 2 is correct** → Cyclical unemployment results from economic downturns.
  - **Statement 3 is correct** → Structural unemployment arises due to a skill mismatch.
  - **Statement 4 is correct** → Frictional unemployment is temporary and normal.
- Since **all four statements are correct**, the correct answer is:
- **(d) All four.**

Key Takeaways

- **Disguised Unemployment** → More workers than needed, common in agriculture.

- **Cyclical Unemployment** → Job losses due to economic downturns (e.g., recessions).
- **Structural Unemployment** → Skill-job mismatch due to economic and technological changes.
- **Frictional Unemployment** → Temporary job transition phase, normal in all economies.

23. Answer: (a)

Explanation:

- **Statement 1: NNP is calculated by subtracting depreciation from Gross National Product (GNP).**
- **Correct.**
  - Net National Product (NNP) is derived from Gross National Product (GNP) by accounting for **depreciation** (wear and tear of capital goods).
  - Formula: **NNP = GNP – Depreciation**.
- **Statement 2: NNP at market price accounts for indirect taxes and subsidies, whereas NNP at factor cost does not.**
- **Correct.**
  - **NNP at Market Price (MP) = NNP at Factor Cost (FC) + Indirect Taxes – Subsidies**.
  - **NNP at Factor Cost (FC)** is the income earned by factors of production, whereas **NNP at Market Price (MP)** includes taxes and subsidies.
- **Statement 3: NNP always remains higher than GNP in an economy due to depreciation adjustments.**
- **Incorrect.**
  - **Depreciation is subtracted from GNP to get NNP**.
  - Since depreciation is a **negative adjustment**, NNP is always **lower** than GNP, **not higher**.
- Answer Choice Selection
  - **Statement 1 is correct.**
  - **Statement 2 is correct.**
  - **Statement 3 is incorrect.**
- Thus, the correct answer is:
- **(a) 1 and 2 only**

Key Takeaways

- **Break down each statement** into conceptual parts and check their validity individually.
- **Use formulas and definitions** to confirm accuracy (e.g., NNP = GNP – Depreciation).
- **Identify logical fallacies**—statement 3 contradicts the definition of NNP, making it wrong.
- **Eliminate wrong options systematically** to arrive at the right answer.

24. Answer: (c) 1, 2, and 3

Explanation:

- **Step 1: Understanding Fiscal Deficit**
  - **Fiscal deficit = Total Government Expenditure – Total Government Revenue (excluding borrowings).**
  - A **higher fiscal deficit means the government is spending more than it earns**, requiring borrowing to finance the shortfall.
- **Step 2: Evaluating Each Action**
- **Statement 1: Providing direct cash transfers to farmers**
  - Direct cash transfers (such as **PM-KISAN**) involve **government expenditure without immediate revenue generation**.
  - This **increases government spending**, widening the fiscal deficit.
  - Since it does not bring in additional revenue, **it contributes to an increase in the fiscal deficit.**
- **Statement 1 is correct.**
- **Statement 2: Reducing the corporate tax rate**
  - Corporate tax is a major source of government revenue.
  - **Lowering the corporate tax rate reduces the revenue collected from businesses.**
  - **Example:** India reduced the **corporate tax rate from 30% to 22% in 2019**, leading to a revenue shortfall.
  - A reduction in tax revenue without compensatory spending cuts **increases the fiscal deficit**.
- **Statement 2 is correct.**
- **Statement 3: Increasing public sector wages without raising tax revenues**
  - Higher wages for government employees increase **recurring expenditure**.

- If this is not offset by **higher tax collection or spending cuts in other areas**, it leads to **higher government spending and a rise in fiscal deficit**.
- **Example:** Implementation of **7th Pay Commission recommendations** led to a **significant rise in fiscal burden**.

- **Statement 3 is correct.**
- **Step 3: Selecting the Correct Answer**
  - **Statement 1 is correct** (Direct cash transfers increase government spending).
  - **Statement 2 is correct** (Reducing corporate taxes lowers government revenue).
  - **Statement 3 is correct** (Increasing wages without revenue increase widens the deficit).
- Since **all three contribute to a higher fiscal deficit**, the correct answer is:
- **(c) 1, 2, and 3.**

Key Takeaways

- Fiscal deficit increases when government spending rises without corresponding revenue growth.
- Providing direct cash transfers raises expenditure, leading to a deficit increase.
- Reducing corporate tax decreases revenue, widening the fiscal gap.
- Increasing public sector wages raises government spending, worsening the fiscal deficit.
- Managing fiscal deficit requires balancing revenue generation (taxes, economic growth) and expenditure control.

25. Answer: (a) 1 and 2 only

Explanation:

- **Step 1: Understanding Primary Deficit**
  - **Primary Deficit = Fiscal Deficit – Interest Payments**
  - It measures **the government's borrowing needs, excluding interest payments on past debt**.
  - A **lower primary deficit** suggests better fiscal discipline, while a **higher primary deficit** indicates rising government expenditure beyond interest payments.
- **Step 2: Evaluating Each Statement**
- **Statement 1: A declining primary deficit suggests that the government is moving towards fiscal discipline.**
  - **Correct** because a lower primary deficit means the government is **reducing its reliance on borrowing for non-interest expenses**.
  - It indicates **controlled spending, better revenue collection, and improved fiscal management**.
  - If the primary deficit reaches **zero or becomes a surplus**, it means the government's revenue is enough to cover its non-interest expenditures.
  - **Example:** If India's primary deficit reduces over consecutive years, it shows **fiscal consolidation** efforts.
- **Statement 1 is correct.**
- **Statement 2: A rising primary deficit means the government is borrowing more for non-interest expenditure, increasing the overall debt burden.**
  - **Correct** because a higher primary deficit means the government is **spending more than it earns, excluding interest payments**.
  - It signals that the government is **increasing its debt burden to meet current expenditures**.
  - **Example:** If India's primary deficit increases due to **higher subsidies or social spending**, it means more borrowing is needed.
- **Statement 2 is correct.**
- **Statement 3: If the primary deficit is negative, it means the government's revenue exceeds its total expenditure, including interest payments.**
  - **Incorrect** because a **negative primary deficit is called a Primary Surplus**, which means revenue exceeds **non-interest expenditure**, but **does not cover total expenditure, including interest payments**.
  - A **negative fiscal deficit** (not primary deficit) would indicate that revenue exceeds **all expenses, including interest payments**.
  - **Example:** If India's primary deficit is negative, it means **current revenue covers all new expenses but not past interest liabilities**.

- **Statement 3 is incorrect.**
- **Step 3: Selecting the Correct Answer**
  - **Statement 1 is correct** (A declining primary deficit shows fiscal discipline).
  - **Statement 2 is correct** (A rising primary deficit means more borrowing for non-interest expenses).
  - **Statement 3 is incorrect** (A negative primary deficit means revenue exceeds non-interest expenditure, not total expenditure).
- The correct answer is:
- **(a) 1 and 2 only.**

Key Takeaways

- A declining primary deficit indicates better fiscal management and lower reliance on borrowing.
- A rising primary deficit suggests higher government spending, leading to increased borrowing.
- A negative primary deficit (Primary Surplus) means revenue exceeds non-interest spending but not total expenditure.
- Fiscal discipline requires reducing the primary deficit through revenue growth and expenditure control.

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