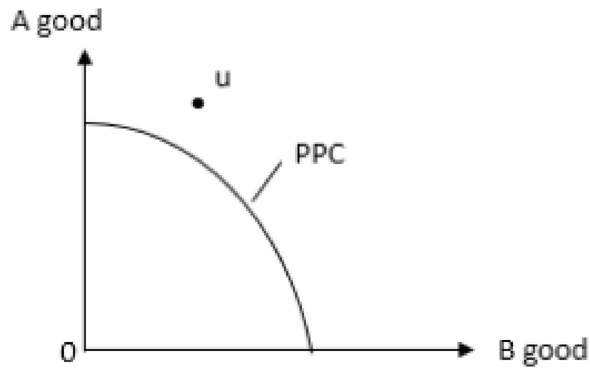
Marking Scheme - Essay

1.

i) What is meant by scarcity? Explain the problem of scarcity using a production possibilities curve.

- Scarcity is a situation in which the needs and wants of an individual or group of individuals exceed the resources available to satisfy their needs.
- It simply means that people want more than what is available. Scarcity limits us both as a society and as individuals. Limited income keep up from doing and having all that we might like. As a society, limited resources fix a maximum on the amount of goods and services that can be produced.



- The above PPC shows all the alternative product combinations possible for an economy if all the given resources are used to their maximum efficiency under a given state of technology.
- However, the economy cannot attain a point lying outside the curve ("u") even though it is desirable.
- This is because of scarcity, the unlimited needs of the people cannot be met with existing resources and economy's maximum production possibility is limited to any point lying on the curve.

ii) Why productive inefficiency and allocative inefficiency are considered wasteful in resource utilization?

- When a firm does not produce a particular good at the minimum cost, productive efficiency cannot be achieved. That is the firm fails to produce the maximum output from a unit of input, or produce a unit of output from the least amount of resources.
- This phenomena in the context of the whole economy is, the economy fails to produce the maximum output from the available resources. Such an economy will not be able to fulfill the two conditions; full employment and full production. Thus, the point of production will not be on the production possibility curve.

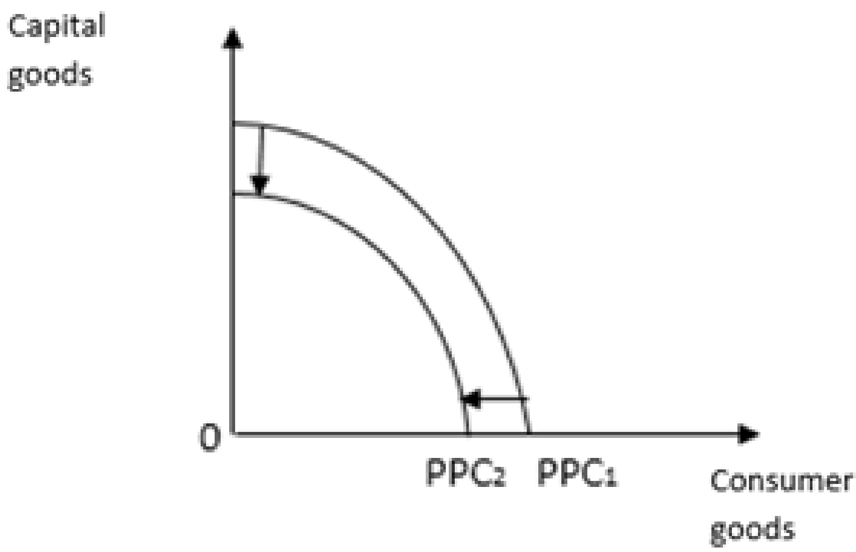
- If the economy fails to produce the most desirable output production combination by the society, the economy will be in the condition of allocative inefficiency.
- If the price paid by consumers to acquire a particular good or service is not equal to the value of resources endowed in production, there will be an over-production of under-production. Thus, the resources will be wasted.

iii) What are the main functions of an economic system?

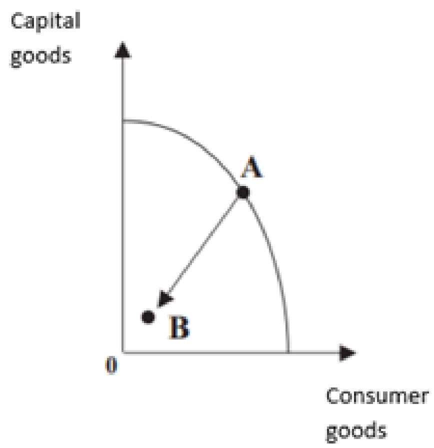
- An economic system is the way a society sets about allocating which goods to produce and in which quantities or it is the method by which countries find answers for the fundamental economic problems.
- An economic system performs three main functions, namely:
  - What and how much should be produced? (production decision)
  - How should the goods and services be produced? (choice of techniques decision)
  - For whom to produce? (distribution decision)

iv) Explain what happens to a country's production capacity due to a pandemic such as Covid – 19 using a production possibilities curve. (5 marks)

- The production capacity of an economy during a pandemic situation like Covid – 19 depends on the measures taken to control the spread and how these measures will affect the economy's resources and productivity.
- If the pandemic affects the size of the labour force or its productivity at a large scale, the production possibility of the economy will decrease. Thus, shifting the curve to the right (inward shift).
- It can be depicted in a PPC as follows;



- If the pandemic's effect on the labour force is not very large, the productio possibility or economic capacity will not be harmed. In such a situation, the PPC will not shift inwards. However, the domestic and global measures taken to control the pandemic (eg: lockdowns, closing airports & ports, disruptions in supply chains) may affect the production process of the economy. In such situations the economy will be under-producing.
- If this is the phenomenon, the PPC will not shift to the right, only the production point will move inwards, as depicted below;



v) Explain why the division of labour causes increases in the level of production in an economy.

- **<u>Increase in productivity</u>**
  - Division of labour leads to specialization. That is per unit labour productivity will increase significantly.
  - Eg: When there is division of labour, one employee will produce 4800 pins per day. If there is no division of labour, an employee can produce either only 1 or a maximum of 20 – Adams Smith's example on division of labour
- **<u>Appointing the most appropriate employee for the particular task</u>**
  - Different employees have different skills and abilities. Through division of labour employees can select the task that fits them the most and specialize in it. This will increase productivity. If one person is required to do many tasks, he or she may not be equally good in all of them, thus productivity will decrease.

- **Increase in experience and skills**
  - By doing the same task over and over again an employee's experience and skills in that particular task will increase. This will increase the quality and speed of production.
- **Innovations in production techniques**
  - Due to specialization in the task, the employee may be able to discover new and faster methods for production. New machinery may also be innovated due to this.
- **Reduce time consumption**
  - Under division of labour, one person will only be involved in one task. Therefore training and development is only needed in the particular task. There is no need to spend a long period of time on training in every task. This will save both time and money. Time is also saved since employees are not required to switch from one task to another.

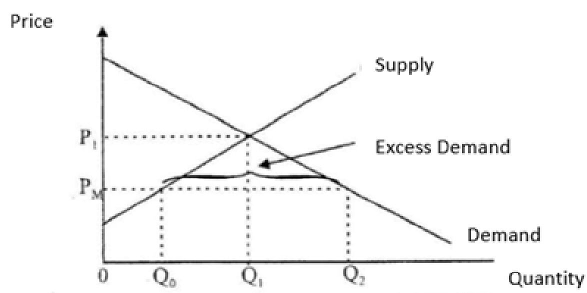
2.

i) Distinguish between a 'price ceiling' and 'price floor'. (4 marks) (A/L 2020)

- Price ceiling is a legally set maximum price that could be charged for a particular product and service.
- After setting the price ceiling it will be illegal to sell that particular product at any price higher ceiling price.
- Price floor is a legally set minimum price that could be charged for a particular product or service.
- After setting a price floor it will be illegal to sell that particular product at any price lower than floor price.

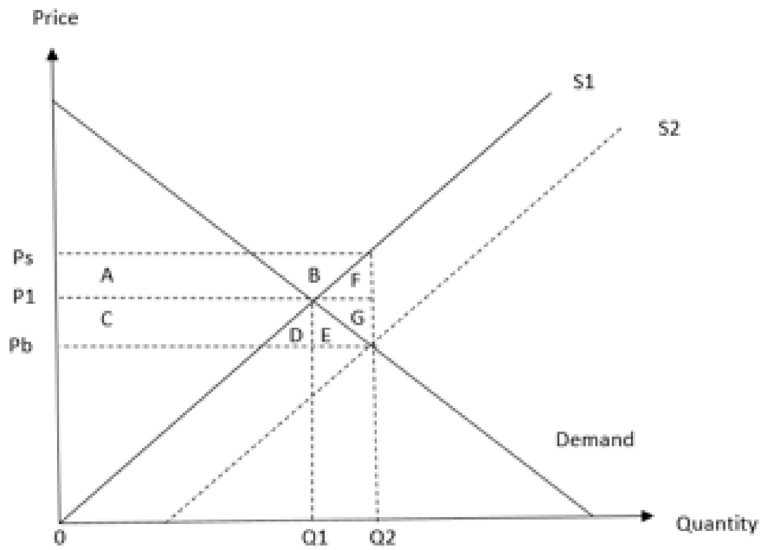
ii) Why does a price ceiling create an excess demand for a good? Explain your answer using a diagram. (4 marks) (A/L 2020)

- A price ceiling is set up with the objective of providing a benefit to consumers since the current market price is unreasonable to consumers.
- When a price ceiling is imposed there will be an excess demand in the market.



iii) Why does a producer subsidy create a deadweight loss? Illustrate your answer using an appropriate diagram. (4 marks) (A/L 2020)

- Similar to any other intervention or price control method, granting a subsidy will also cause a deadweight loss. Even though both producers and consumers will have a surplus, there will be an overall loss to the society. This is because the cost of the subsidy to society is higher than the surplus.
- In a market with a subsidy the good will be bought more than in a competitive market. This is due to the reduction in price due to the subsidy. However, the relief gained by consumers when buying the additional units is lower than the cost incurred by the government for the subsidy.
- A subsidy is similar to a gift given by the government. The cost incurred by the consumer to get the gift is lower than the actual cost incurred by the government.



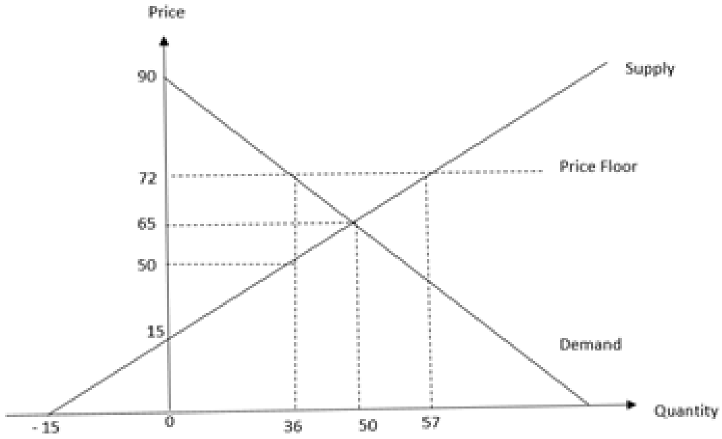
- Increase in consumer surplus after subsidy = C + D + E
- Increase in producer surplus after subsidy = A + B
- Increase in economic surplus after subsidy = A + B + C + D + E
- Government subsidy expenditure = A + B + C + D + E + F + G
- Loss in welfare (deadweight loss) = (A + B + C + D + E + F + G) – (A + B + C + D + E)

  = F + G

iv) A competitive market has a demand function given by the equation Qd = 180 – 2P, and a supply function given by the equation Qs = – 15 + P. Calculate the amount of deadweight loss that would result from a price floor imposed in this market at Rs. 72 per unit.

- Market equilibrium:

Qd	= Qs
180 – 2P	= – 15 + P
195	= 3P
P	= 65
Q	= 180 – 2(65)
	= 180 – 130
	= 50



Before price floor:

Consumer surplus $= \frac{(90-65)}{2} X\,50$

$= \frac{1250}{2}$

$= 625$

Producer surplus $= \frac{(65-15)}{2} X\,50$

$= \frac{2500}{2}$

$= 1250$

Economic surplus $= 625 + 1250$

= Rs. 1875

After price floor:

Consumer surplus $= \frac{(90-72)}{2} X\,36 \quad = \frac{18\,X\,36}{2}$

$= \frac{648}{2}$

= Rs. 324

Producer surplus $= \frac{(57+21)}{2}$ X 36 $\quad = \frac{2808}{2}$

$= 1404$

Economic surplus $= 324 + 1404$

= Rs. 1728

Deadweight loss = Economic surplus before price floor – Economic surplus after price floor
= 1875 – 1728
= Rs. 147

3.

i) What is a production function? Distinguish between short run and long run production functions. (03 marks)

- An equation, table or graph showing the relationship between inputs and the maximum amount that can be produced within a given period of time within a given level of technology.
- The production function of a production process which utilizes only labour (L) and capital (K) can be depicted as follows;
  $Q = f(K, L)$
- A production process requires not only labour and capital, but time as well. Thereby, in order to relate time and its effect on the production process, the process is divided into two time periods. These two periods are the short run and long run.
- In a short run production function there are 2 factors, which are variable factors (V) and fixed factors (F). During the short run a firm increases labour and materials while keeping fixed factors such as capital constant. A short run production function can be depicted as follows;
  $Q = f(V, F)$
- The long run is the time period in which all the factors must be increased. In other words, no factor of production is fixed. Thereby, all factors are variable, including capital.

ii) What are the reasons for economies of scale and diseconomies of scale? (04 marks)

- Economies of scale
  - Specialization of labour
  - Management economies
  - Efficient use of capital and equipment
  - Marketing economies
  - Financial economies
  - Risk bearing economies

- Diseconomies of scale
  - Management complexities in large scale plants
  - After a certain point the benefits of large scale purchasing may diminish and cost of production will increase.
  - The sense of alienation among workers in large scale plants will reduce their efficiency and productivity.
  - Increase in transportation cost due to opening of new branches far from the main branch.
  - Disputes and strained relationships with workers will reduce productivity and increase the cost.

iii) What is the relationship between economic profit, producer surplus and fixed cost? (03 marks)

- Economic profit is the difference between total cost (fixed cost + variable cost) and total revenue.
- Production surplus is the difference between total variable cost and total revenue.
- When calculating the economic profit, the total fixed cost is taken into consideration however, but it is not considered in calculating the production surplus.
- Thereby, the producer surplus will be greater than the economic profit by the value of the total fixed cost. In other words, the difference between the producer surplus and the economic profit is the total fixed cost.

iv) What is economic rent? Under what conditions a factor of production can earn an economic rent? (04 marks)

- Economic rent is the return that the factor owner receives over and above the expected return to provide a factor of production for a particular economic activity.
- In other words extra return received on top of expected return by the factor owner to continue the supply of a particular factor of production in to a particular economic activity.
- Economic rent is the income received by the owner of a factor of production over and above the opportunity cost (transfer payment) of using that factor.
- The amount of economic rent earned is determined based on the elasticity for the particular factor of production.
- Under inelastic factor of production supply factor owner receives more economic rent whereas under elastic factor of production supply factor owner receives less economic rent.

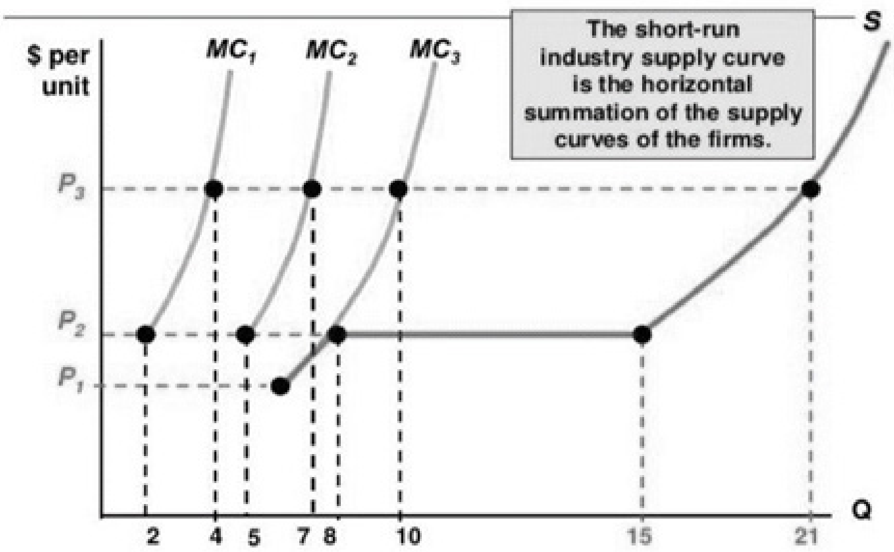
v) How do you derive the industry's short run supply curve from the firms' short run supply curves in a perfectly competitive industry? Illustrate your answer with appropriate diagrams. (04 marks)

Firm's supply curve

- Perfectly competitive firm supplies a quantity at which it either maximizes profits or minimizes losses.
- This is achieved by operating at the output where MC= MR.
- Further, if market price covers average variable cost, perfectly competitive firm can continue its operations.
- Therefore, short run supply curve of a perfectly competitive firm is marginal cost curve above variable cost point.

Industry's supply curve

- Industry's supply curve represents different quantities supplied (by the entire industry) at different market prices while number of firms in an industry and the capacity of each firm is held constant.
- In other words, at a particular price, industry volume (quantity) represents summation of each firm's supply.
- Thereby, if all marginal cost curves of individual firms above their minimum variable cost points horizontally aggregate, the industry supply curve can be obtained



4.

i) State whether the following activities are included in the calculation of Sri Lanka's Gross Domestic Product and explain the reasons for your answer. (06 marks)

a. An investor purchases Rs. 1 million if newly issued shares of a Sri Lankan company.

- Not included
- It is a pure financial transaction

b. Construction of a new house worth of Rs. 50 million.

- Included
- There is a value addition

c. The purchase of Rs. 50 000 worth of fish by a restaurant in Colombo from a fisherman

- Not included
- The fish stock is an intermediate good used in the production of the restaurant service.

d. Collection of Rs. 5 000 worth of honey bee by a farmer from a nearby forest.

- Included
- An economic activity included within the economic boundary

e. A research project costing Rs. 10 million completed by a university research team on the impact of COVID-19.

- Included
- An economic activity included within the economic boundary

ii) You have been given the following data for a hypothetical economy

Item	Value (Rs. Billion)
Aggregate consumption expenditure	10 000
Gross domestic capital formation	4 000
Export of goods and services	3 500
Import of goods and services	4 500
Net primary income from the rest of the world	- 400
Net current transfers from the rest of the world	1 000

Calculate the following based on the following data

a. Gross national income (02 marks)

Gross domestic production	=	Aggregate consumption expenditure + Gross domestic capital formation + (Export of goods and services - Export of goods and services)
	=	10 000 + 4 000 - (3 500 - 4 500)
	=	Rs. 13 000 billion (1 mark)

Gross domestic income	=	Gross domestic production + Net primary income from rest of the world
	=	13 000 + (- 400)
	=	Rs. 12 600 billion (1 mark)

b. Gross national income (02 marks)

Gross domestic savings	=	Gross domestic production - Aggregate consumption expenditure
	=	13 000 - 10 000
	=	Rs. 3 000 billion (1 mark)

Gross national savings	=	Gross domestic savings + Net primary income from rest of the world + Net current transfers from rest of the world
	=	3 000 + (- 400) + 1 000
	=	Rs. 3 600 billion (1 mark)

iii) The following model represents a closed economy with no government.

C = 500 + 0.8 Y I = 600 (Values are in Rs. Billion)

a. How much is the autonomous expenditure in this economy? (02 marks)

Autonomous expenditure = Autonomous consumption + Autonomous investment
= 500 + 600
= Rs. 1 100 billion

b. What is the equilibrium level of aggregate output? (02 marks)

- Equilibrium income:

  Y = C + I
  Y = 500 + 0.8 Y + 600
  Y = 1 100 + 0.8 Y
  0.2 Y = 1 100
  Y = Rs. 5 500 billion

c. What is the value of investment multiplier? (02 marks)

$$\text{Investment multiplier} = \frac{1}{1-MPC}$$

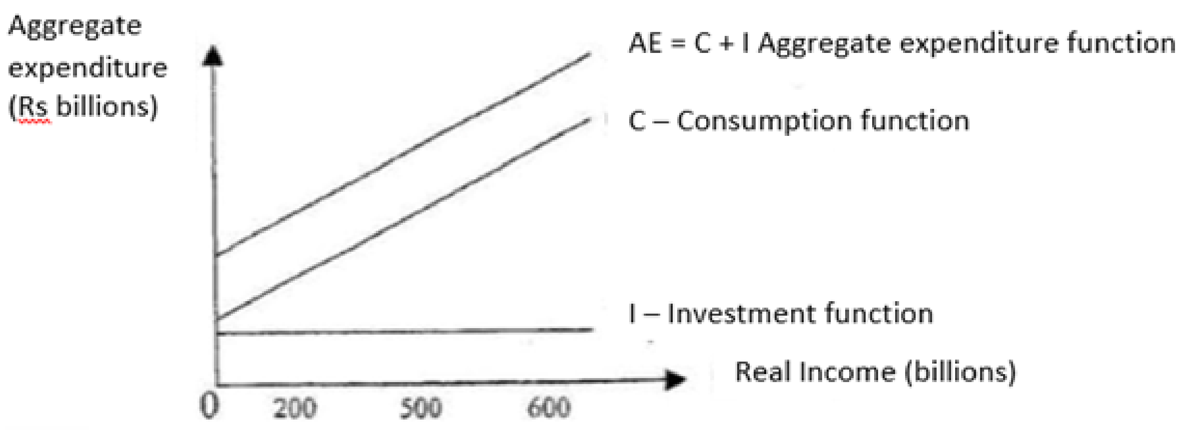
$$= \frac{1}{1-0.8}$$

$$= \frac{1}{0.2}$$

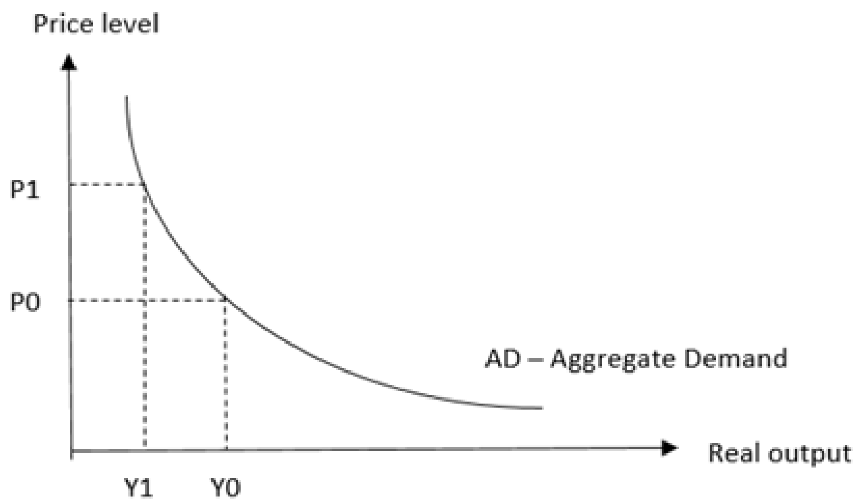
$$= \underline{\underline{5}}$$

iv) Explain the differences between aggregate expenditure function and aggregate demand curve using appropriate diagrams. (05 marks)

- The aggregate expenditure function depicts the money spent by business firms and economic agents to purchase final goods at different income levels.
- In a simple economy the aggregate expenditure function will be an aggregate of the consumption and investment functions.
- The aggregate expenditure function can be depicted through a diagram as follows;



- The aggregate demand curve depicts the aggregate of the different quantities of goods that domestic consumers, business firms, government and international traders at different price levels.
- Aggregate demand curve can be depicted as follows;



5.

I) What is the quantity theory of money? (04 marks)

- Quantity theory of money is the theory that explains there will be a positive (direct) relationship between general price level (P) and the money supply of the economy (M) when velocity of money (V) and physical volume of output (T) is constant.
- Therefore quantity theory of money describes that change in money supply make an increase in general price level.
  Ex: If money supply doubles price level doubles.
- Quantity theory of money can be explain using exchange equation of money.

$$\boxed{V \times M = P \times T}$$

  - V - Velocity of money (average frequency that a unit of money is spent on goods and services produced domestically in a specific period of time)
  - M - Money supply (quantity of money)
  - P - Price level
  - T - Physical volume of output (this is constant when an economy reaches its full employment)

- Quantity theory of money is based on main two assumptions;
  - a) Velocity of money (V) is constant.
  - b) Physical volume of output (T) is constant since economy has reached its full employment level

II. What are the costs of inflation? (04 marks)

- Cost of living goes up resulting lower living standards for the general public
- Inflation distorts many types of economic behavior and imposes costs upon economic agents.
- Unfair income distribution: Weaker social groups in society such as old people on fixed pensions lose, while others in stronger bargaining positions gain.
- Inflation tends to redistribute wealth from lenders or creditors to borrowers or debtors.
- Causes overvaluation of exchange rate resulting an adverse trade balance.
- Uncertainties affect the behavior of firms and imposes costs upon them. Long term planning becomes very difficult. Firms may be tempted to divert investment funds out of productive investment into commodity hording and speculation.
- Shoe leather and menu costs: In a period of rapid inflation, consumers spend more time and effort shopping around checking on which price have or have not risen. Menu costs are incurred by firms or producers as a result of having to adjust printed price, costs, vending machines, etc. more quickly.
- Decline in economic growth
- Increase in imports
- Decrease in exports
- Decrease in investments

III. What are the major determinants of demand for money? (03 marks)

- Real income
- Interest rates
- Price levels
- Expectations about future inflation rate and interest rate
- Innovations in the money market

IV) State four core functions of the Central Bank of Sri Lanka. (04 marks)

- Administering the monetary policy
- Maintaining the official foreign reserves of the country
- Currency issuing and management
- Licensing, regulation and supervision of the banking system and other financial institutions within the financial system.
- Act as a banker to the state
- Assist government in formulating and implementing macro-economic policies.

V) Assume that in a hypothetical economy during a given period of time, total money stock (M) was Rs. 6 400 billion, total amount of bank deposits (D) held by the public was Rs. 5 200 billion, statutory reserve ratio was 10% and the value of excess reserves held by the bank was Rs. 280 billion.

a. What was the total amount of high powered money in this economy? (03 marks)

High powered money (H)	=	Currency held by public (Cp)	+	Currency held with commercial banks (Ckb)
Currency held by public (Cp)	=	Total Money supply (M)	-	Bank deposits (D)
	=	6 400	-	5200
	=	1200		
Currency held with commercial banks (Ckb)	=	Required reserves (RR)	+	Excess reserves
Required reserves (RR)	=	0.10	X	5200
	=	5200		
Excess reserves	=	280		
Currency held with commercial banks (Ckb)	=	520	+	280
	=	800		
High powered money (H)	=	Cp	+	Ckb
	=	1200	+	800
	=	Rs. 2 000 billion		

b. What was the value of money multiplier? (02 marks)

$$\text{Money multiplier (M)} = \frac{M\ (Total\ money\ Supply)}{H\ (High\ powered\ money)}$$

$$= \frac{6\,400}{2\,000}$$

$$= \frac{16}{5}$$

$$= \underline{\underline{3.2}}$$

6.

i) Distinguish between comparative advantage and competitive advantage. (4 marks)

<u>**Comparative advantage**</u>

- Comparative advantage means one country is having lesser opportunity cost than another country in producing a particular commodity. Thus, the country with lesser opportunity cost can produce that particular product at a lesser resource cost than the other country.
- The sources of comparative advantage are, the differences in factor endowment,economies of scale, productivity, government policies.

<u>**Competitive advantage**</u>

- Competitive advantage is that with the same factor endowment and productivity with the capability to produce goods and services, a country is providing the good or service to the consumer in a better way than any other country.
- The sources of competitive advantage are, advanced research & development, intellectual property rights, lower productions cost, higher quality of the good etc.

ii) What are the major obstacles Sri Lanka encounters to achieve a rapid growth in export earnings? (5 marks)

- There is no substantial diversification in products that are exported. Still more than half of the export contribution is dependent on two main exports, tea and textiles & garments.
  Ex: In 2020, contribution to total exports by tea exports 12.4% and by textiles and garments exports 44%.

- There is no substantial diversification in markets to which exports are exported. More than 2/3 of the exports are still sent to Europe and USA.
  Ex: In 2020, from total exports 24.9% exported to USA, 14% exported to EU other, 9% to UK, 5% to Germany
- There are no substantial investments in export oriented industries. In the East Asian countries for their export growth the main contribution is made by FDIs in export oriented industries. However, Sri Lanka has been failed to attract any substantial amount of investments on this front. Even the FDIs those have been attracted were attracted on infrastructure development.
- Relatively higher cost and low productivity in tea industry compared to other competitive tea exporting countries.
- Reduction in labour force for export industries such as tea and increase in cost of labour Weaknesses and inefficiencies of export development board.
  Ex: No proper strategic vision, no resources for the export expansion, weaknesses in supervision of export development promotions

iii) What is meant by official reserves in a country? List its major components. (5 marks)

- Official foreign reserves is the amount of highly liquid foreign assets that is held by the government and central bank as at a particular date.
- The major components of Sri Lanka's foreign reserves are;
  - Deposits in foreign banks
  - Monetary gold
  - Special Drawing Rights (SDR)
  - Foreign securities that are certified by foreign governments

iv) Is it possible to have a comparative advantage in the production of a good without having an absolute advantage? Explain your answer with a numerical example. (6 marks)

- Yes, it is possible to have a comparative advantage even though there is no absolute advantage for that country.
- According to the theory of absolute advantage, a country is said to be more efficient than another country in the production of a given commodity.
- The theory of comparative advantage assumes that even though a country has an absolute disadvantage in the production of two types of goods, a beneficial trade will occur when the country produces and exports the goods which have the lowest opportunity cost and imports the goods which have a comparative disadvantage.

Example

- The quantities of automobile and computer which could be produced by two countries A and B with equal quantities of inputs are given below.

	Country A	Country B
Automobiles	1000	600
Computers	800	400

- According to the above example, country A has the absolute advantage of producing both automobile and computers. However, country B does not have absolute advantage. Therefore, B has a problem of engaging in trade with A.
- But according to the theory of comparative advantage, the opportunity costs in production of each good are given below.

	Country A	Country B
Opportunity cost of Automobiles	0.8	0.66
Opportunity cost of Computers	0.25	1.5

- Hence, even though country B does not have absolute advantage in producing automobiles, country B has the comparative advantage in producing automobiles.

7.

i) Mention four major economic functions of government in a market economy.

- Improve efficiency in resource allocation (inefficiency occurs due to externalities, provision of merit goods and public goods)
- Ensure fair distribution of income
- Achieve macroeconomic stability
- Improve economic growth and sustainable development
- Establish the legal framework for efficiently functioning market system (enforcement of law and contracts)
- Promote infrastructure development
- Regulations to ensure competition

ii) What are the obstacles to achieve an efficient allocation of resources in a market economy?

- Non allocation or under-allocation of resources to public goods and quasi-public goods
- Externalities in production and consumption
- Over-utilization of common resources
- Income inequality
- Market power
- Factor immobility
- Information asymmetry
- Missing markets

iii) Define pure public goods, merit goods, common resources and natural monopolies

- Pure public goods are non-excludable (no ability to exclude person/s from the consumption of a good) and non-rival (one additional person's consumption does not deplete the benefit or utility of existing customers) in consumption
- Merit goods are those goods and services consumption and production of which generates positive externalities. Therefore, social benefits of consumption exceeds private benefits.
- A common resource is rival and non-excludable. It is rival because its use by one person decreases the quantity available to someone else.
- In a natural monopoly, economies of scale exist over the entire range of output for which there is a demand. The firm which is already in operation has an overwhelming advantage over potential competitors.

iv) Explain why taxes are necessary for a country and briefly outline the desirable properties of a good tax.

Importance of taxes

- Raising revenue to pay for government expenditure
- The correction of market failures Tax monopoly profits
  - o Finance provision of public goods and merit goods
  - o Discourage the consumption of demerit goods
  - o Alter the distribution of income to reduce inequalities in income and wealth
- Keynesian economic management (discretionary fiscal policy)
  - o Controlling the level of aggregate demand to achieve the objectives full employment and stable economic growth, without an excessive inflationary cost
- Mitigation of balance of payments difficulties
- Protection of infant industries

Desirable properties of a good tax system

- Equity
- Economy
- Certainty
- Efficiency
- Flexibility
- Simplicity
- Convenience

v) What is meant by the 'primary balance' of the government budget? Why is it considered to be important to have a surplus in the primary balance?

- The primary balance of the government budget is the difference between total government revenue including grants and total government expenditure less interest payments (current + capital + lending minus repayment).
- Alternatively, it can be defined as the difference between overall budget deficit and the interest payments.
- The primary budget balance, defined as the budget balance net of interest payments, is a key determinant of government debt dynamics.

- Stabilizing the government debt-to- GDP ratio and subsequently putting it on a declining path towards the reference value requires a sufficiently large primary surplus to be generated over an extended period of time if the interest rate-growth differential is positive, as conventionally assumed.
- Primary deficit shows the borrowing requirements of the government including interest payment for meeting expenditure. Thus, if primary deficit is zero, then fiscal deficit is equal to interest payment. Then it is not adding to the existing loan.
- Primary balance is generally used as a basic measure of fiscal irresponsibility. It can be said to provide an indicator of current fiscal effort, since interest payments are predetermined by the size of previous deficits.
- For countries with a large outstanding public debt relative to GDP, achieving a primary surplus is normally viewed as important, being usually necessary (though not sufficient) for a reduction in the debt/GDP ratio.

Marking Scheme - MCQ

Questions	Answer	Explanation
1	I	
2	III	
3	II	
4	III	
5	IV	
6	II	
7	I	
8	I	
9	I	
10	IV	
11	III	
12	IV	
13	III	
14	III	
15	I	
16	II	
17	IV	

18	IV	
19		
20	I	
21	I	
22	I	
23	II	
24	II	
25	III	
26	I	
27	I	
28	IV	
29	I	
30	IV	
31	III	
32	IV	
33	IV	
34	III	
35	I	
36	II	

37	II	
38	I	
39	IV	
40	IV	

Mock Paper Class – Economics

Paper 15 (MCQ)

1. The natural rate of unemployment in an economy is 5%. What will happen if a government persists in trying to achieve a target rate of unemployment of 3% by expansionary monetary policy?

I. an accelerating rate of inflation
II. a diminishing rate of inflation
III. a high but constant rate of inflation
IV. a negative rate of inflation
V. none of the above

2. In a closed economy, the marginal propensity to save is 0.4 and the marginal propensity to pay taxes is also 0.1. These values are constant and do not vary with the level of income. What will be the increase in national income if there is an injection of 100 million into the circular flow?

I. 1000 million
II. 500 million
III. 200 million
IV. 100 million
V. 50 million

3. Other things being equal, what is most likely to be reduced by falling labour productivity

I. the balance of trade deficit
II. the internal value of money
III. the level of unemployment
IV. the rate of domestic inflation
V. none of the above

4. The table shows a country's consumer prices index (CPI) for March and April 2018.

	CPI
March 2018	151.3
April 2018	148.6

Which statement correctly describes what happened between these two months?

I. There was a decrease in the annual rate of inflation.
II. There was a decrease in real interest rates.
III. There was an increase in the purchasing power of money.
IV. There was an increase in the standard of living.
V. None of the above

5. A country has a deficit on the current account of its balance of payments. What might help the country to reduce its deficit?

I. a decrease in its rate of income tax
II. a decrease in its tariffs
III. an increase in its level of employment
IV. an increase in its subsidies to exporters
V. none of the above

6. What will be the immediate effect of a devaluation of an economy's foreign exchange rate?

I. The price of imported goods in the domestic currency will fall.
II. The price of imported goods in the domestic currency will rise.
III. The price of imported goods in the foreign currency will fall.
IV. The price of imported goods in the foreign currency will rise.
V. None of the above

7. A country replaces a floating exchange rate system with a managed floating exchange rate system. Which statement is correct?

I. Its central bank would have to intervene more frequently in the foreign exchange market.
II. Its central bank would need to hold fewer foreign currency reserves.
III. The value of its currency would be determined by its major trading partners
IV. The value of its currency would be determined by the value of the US dollar.
V. None of the above

8. A country's terms of trade changed from 100 to 95. What is most likely to have caused this change?

I. a depreciation of the country's currency
II. a reduction in import tariffs
III. a rise in the price of exported goods
IV. an improvement in the balance of trade
V. none of the above

9. In 2020 it was reported that there were concerns when a government kept interest rates very low despite a threat of inflation. Why might the government's policy have caused concern at this time?

I. Low interest rates encourage increased consumer spending.

II. Low interest rates lead to increased spending on capital equipment.

III. Low interest rates mean exports will increase.

IV. Low interest rates will cause an increase in the exchange rate.

V. None of the above

10. Legal reforms to reduce the power of trade unions have reduced inflationary pressures in many countries. Of which policy is this an example?

I. monetary policy

II. demand side policy

III. fiscal policy

IV. supply side policy

V. none of the above

11. What is the most likely aim of a government that increases the level of tariffs on imported manufactured goods?

I. a fall in interest rates

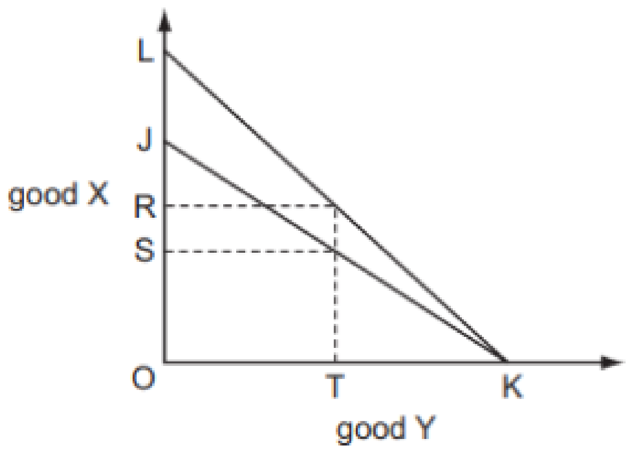
II. a fall in the exchange rate

III. a rise in domestic employment

IV. a rise in the general price level

V. none of the above

12. In the diagram, JK is a country's production possibility curve. LK is its trading possibility curve which shows possible combinations of good X and good Y after specialising in the product in which it has comparative advantage, and then trading this product.



The country consumes OR of good X and OT of good Y. Which quantities of goods X and Y does it produce?

	Good X	Good Y
I	JS	OT
II	OS	OT
III	RS	TK
IV	zero	OK
V	OT	zero

13. A country's terms of trade increased from the base year value of 100 to 120 in the following year. What changes in export prices and import prices would have caused this?

	export prices	import prices
I	decreased 10%	increased 10%
II	increased 10%	decreased 10%
III	increased 20%	unchanged
IV	unchanged	decreased 20%
V	increased 20%	decreased 20%

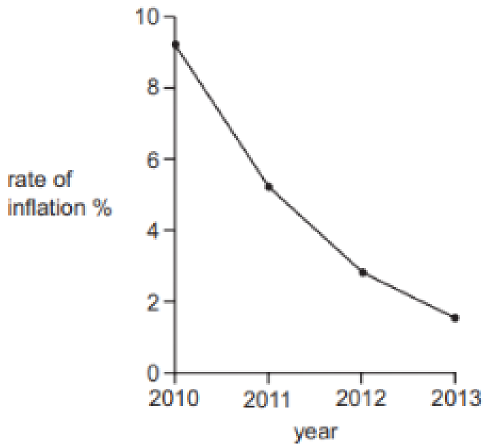
14. In 2020 the US$ exchanged for 181.6 Sri Lankan Rupee. In 2021 the US$ exchanged for 176.1 Sri Lankan Rupee. What would be expected to rise for the United States (US) as a result of this change?

I. the level of unemployment
II. the price of US exports sold in Sri Lanka
III. the rate of imported inflation
IV. the volume of imports
V. none of the above

15. When is a balance of trade deficit likely to be considered a particularly difficult problem for acountry?

I. when the imported goods are identical to domestic products
II. when the imported goods are items of capital equipment
III. when the imported goods are the raw material for exports
IV. when the imported goods are to cover a temporary shortage
V. None of the above

16. The diagram shows the annual rate of inflation in a country between 2010 and 2013. Which statement about the period 2010 to 2013 is correct?



I. The cost of living fell.
II. The price level rose.
III. The Retail Prices Index fell.
IV. The value of money rose.
V. None of the above

17. What will be the probable effect of an increase in indirect taxes on demand-pull inflation and on cost-push inflation?

	demand-pull inflation	cost-push inflation
I	increase	increase
II	increase	decrease
III	decrease	decrease
IV	decrease	increase
V	Unchanged	decrease

18. The table shows the marginal tax rates paid by a country's taxpayers at different levels of income.

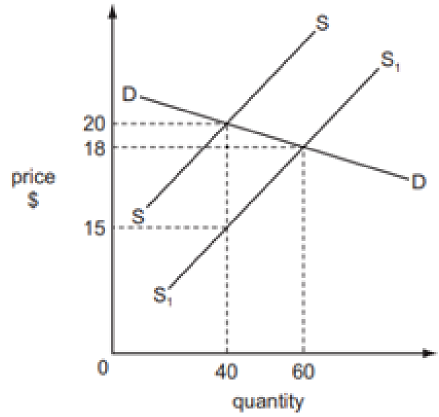
income	tax rate
first \$4000	zero
\$4001 - \$20000	20 %
above \$20000	40 %

What correctly describes this tax?

I. It is regressive over the entire range of income.
II. It is proportional over the income range \$4001 - \$20000.
III. It is proportional over the range of income above \$20000.
IV. It is progressive over the range of income above \$4000
V. None of the above

19. A tax on a product is removed causing supply to increase from SS to S1S1 as shown in the diagram What effect does the move have on government tax revenue and consumer expenditure?

	tax revenue	consumer expenditure
I	reduce by $80	increase by $280
II	reduce by $80	increase by $480
III	reduce by $200	increase by $280
IV	reduce by $200	increase by $480
V	increase by $280	reduce by $80



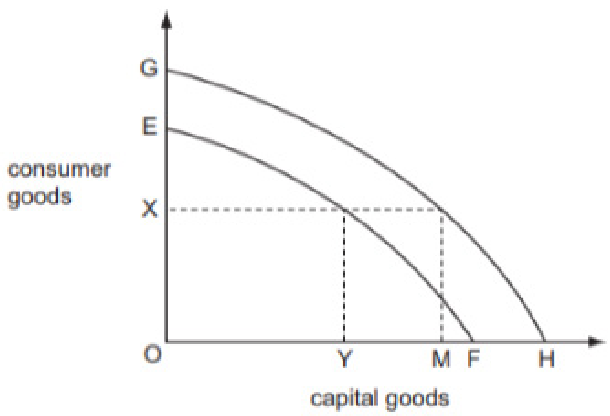
20. Which type of government intervention runs the risk of causing shortages?

I. maximum price controls
II. specific indirect taxes
III. subsidies paid to some producers
IV. taxes on company profits
V. none of the above

21. The price elasticity of demand for a product is unitary for all price ranges. What will be the effect of an increase in its price?

I. an equal proportionate decrease in the amount demanded
II. an equal proportionate decrease in expenditure on the product
III. an increase in the product's percentage of total consumer expenditure
IV. no change in the amount of the product demanded
V. none of the above

22. The diagram shows two production possibility curves (EF and GH), before and after technological progress has taken place.



After technological progress has taken place, what is the opportunity cost in capital goods of producing OX consumer goods?

I. MH
II. OH
III. OM
IV. YF
V. YH

23. In an economy, the marginal propensity to consume of the unemployed is higher than that of taxpayers. The government increases expenditure on unemployment benefits by $10 million. What will the government need to do if it wishes to keep aggregate demand unchanged?

I. raise taxation by less than $10 million
II. raise taxation by more than $10 million
III. raise taxation by $10 million
IV. leave taxes unchanged
V. none of the above

24. Without any change in government policy, what will be the effect of an economic recession on tax revenue and on government expenditure?

	tax revenue	government expenditure
I	decrease	decrease
II	decrease	increase
III	increase	increase
IV	increase	decrease
V	increase	unchanged

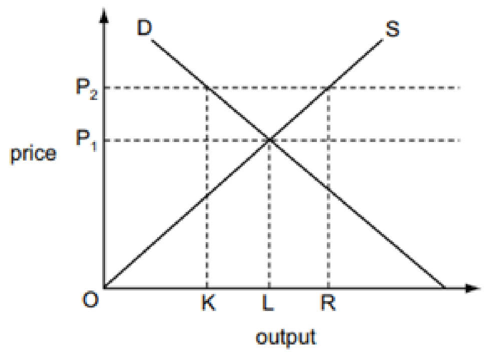
25. Other things being equal, what is likely to result from an increase in interest rates in a country?

I. a capital outflow from the country
II. a depreciation of the country's currency
III. a decrease in consumption
IV. an increase in investment
V. None of the above

26. According to monetarist theory, what will be the short-run effect on the level of output and on the price level of an unanticipated increase in the money supply?

	effect on output	effect on the price level
I	increase	increase
II	increase	no change
III	no change	increase
IV	no change	no change
V	decrease	increase

27. The diagram shows the market supply and demand curves for corn. What should a government do if it is to maintain a minimum price of OP2?

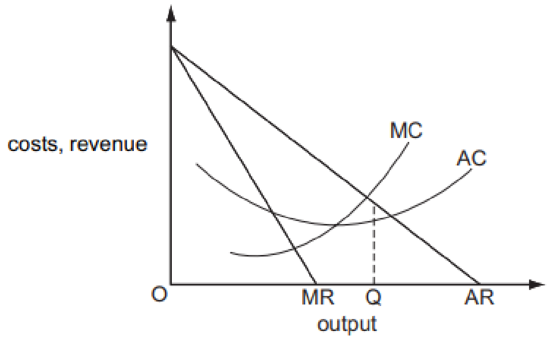


I. buy quantity KR
II. buy quantity LR
III. sell quantity KL
IV. sell quantity OL
V. None of the above

28. A country has a floating exchange rate and an independent central bank with the power to set interest rates. The inflation rate is currently stable at the central bank's target rate of 5%. What is likely to happen to interest rates and to the exchange rate if the bank's target rate was reduced to 2%?

	interest rates	exchange rate
I	decrease	depreciate
II	decrease	appreciate
III	increase	depreciate
IV	increase	appreciate
V	decrease	unchanged

29. The diagram shows a firm's cost and revenue curves. What could explain why the firm produces output OQ?



I. It is operating in a contestable market.
II. It is operating in a perfectly competitive market.
III. It is seeking to maximise profits.
IV. It is seeking to maximise sales revenue.
V. None of the above

30. All firms in an economy produce at levels of output where price and marginal private cost are equal. Why might this not be sufficient to ensure that allocative efficiency is achieved?

I. a small number of buyers and sellers
II. differences in consumers' preferences
III. product differentiation
IV. the presence of externalities
V. All of the above

31. The schedule shows the short-run marginal cost of producing good X

units of X	1	2	3	4	5
marginal cost ($)	50	40	20	20	60

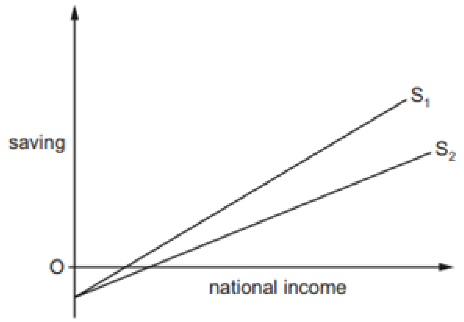
Given that the total fixed cost is $10, what level of output minimises average total cost?

I. 1 units
II. 2 units
III. 3 units
IV. 4 units
V. 5 units

32. What must result from a rise in the supply of money, if the income velocity of circulation remains unchanged?

I. a fall in unemployment
II. a rise in the volume of output
III. a rise in the general level of prices
IV. a rise in the money value of national income
V. None of the above

33. In the diagram, S1 is an economy's initial saving function. If the saving function shifts to S2, what effect will this have on the marginal propensity to consume and on the multiplier?



	marginal propensity to consume	multiplier
I	decreases	decreases
II	decreases	increases
III	increases	decreases
IV	increases	increases
V	unchanged	Unchanged

34. In an economy, the volume of output rises by 2% in a year, while the quantity of money rises by 5%. If the velocity of circulation of money remains the same, what will be the approximate increases in the price level and the money value of national income?

	increase in price level	increase in money value of national income
I	2%	5%
II	2%	7%
III	3%	5%
IV	3%	7%
V	5%	7%

35. Between 2019 and 2020 a country's national output fell by 2%. Over the same period its unemployment rate decreased from 6% to 4%. What could explain this?

I. There was a decrease in labour productivity.

II. There was a fall in the rate of inflation.

III. There was an increase in the long-term potential rate of growth.

IV. There was an increase in the size of the labour force.

V. None of the above

36. In an economy operating below full employment, which combination of changes will definitely result in an increase in national income?

I. a fall in the rate of taxation together with a rise in the saving rate

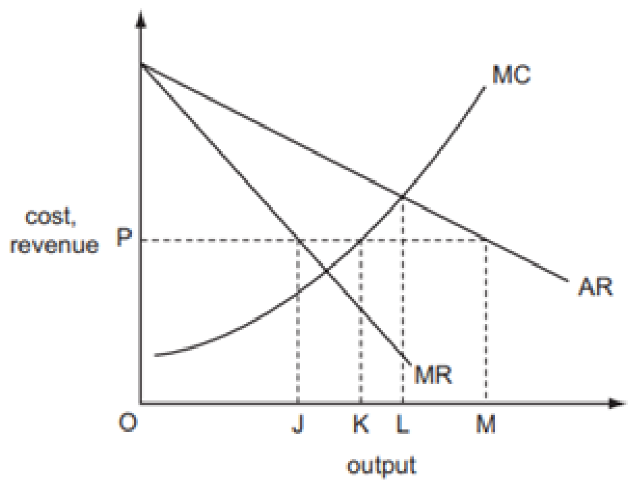
II. a rise in government expenditure together with a fall in the propensity to import

III. a rise in investment expenditure together with a rise in the rate of taxation

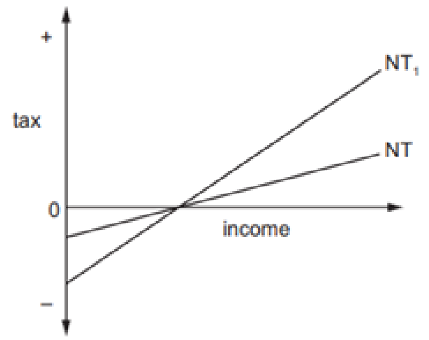
IV. a rise in the propensity to save together with a rise in exports

V. None of the above

37. The diagram shows the initial cost and revenue curves of a profit-maximising monopolist. What output will the firm produce if the government fixes the price at OP?



38. A country has a negative income tax. In the diagram, the curve NT shows the country's initial tax schedule.



What could cause the tax schedule to shift to NT1?

I. a higher marginal tax rate
II. a more equal distribution of income
III. an increase in household disposable income
IV. an increase in the marginal propensity to consume
V. none of the above

39. Over one year the money income in an economy increased by 6%. In the same period prices rose by 4%. What can be concluded from this?

I. Real incomes decreased by 2%.
II. The velocity of circulation decreased by 2%.
III. The money supply increased by 10%.
IV. The volume of output increased by 2%.
V. None of the above

40. What is likely to be the effect on interest rates and the supply of money of a purchase of government securities by a central bank?

	interest rates	money supply
I	increase	increase
II	increase	decrease
III	decrease	decrease
IV	decrease	increase
V	increase	Unchanged