

**01.**

**I. 'When defining full employment of resources using all available resources to its full is not an appropriate definition' explain why term available resources' is not the most suitable term in defining full employment (03 marks)**

- Full employment does not mean that using all available resources in to production, since it is an unsustainable proposition.
- For example if all trees are cut then, humans will not be able to live on earth and all future generations should be suffered due to current production.
- Thus, full employment refers to using maximum amount of resources that can be used in sustainable manner, without sacrificing opportunities of the future generations.
- Thus, using the term 'all available resources' to define full employment is not an appropriate term.

**II. What is meant by economic freedom? Explain the concept, importance and criteria required to create economic freedom (03 Marks)**

- Economic freedom is creating an environment and providing liberty to business firms, consumers and workers to carry out their economic activities (01 Mark)
- This is an essential requirement to make decisions of business, consumer and factor market more efficient. Thereby, this is considered as one of the core founding pillars of market economy. (01 Mark)
- Heritage foundation of USA in 1995 has identified, 10 main criteria required to establish economic freedom in an economy. They are ;
  - a. Business freedom
  - b. Trade freedom
  - c. Monetary freedom
  - d. Government size
  - e. Fiscal freedom
  - f. Property rights
  - g. Investment freedom
  - h. Financial freedom
  - i. Freedom from corruption
  - j. Labor freedom( any of the 02 criteria 01 marks)

**Special Note:-**

- According to the economic freedom index prepared by Heritage foundation of USA, Sri Lanka is in 115<sup>th</sup> place in 2019 (93<sup>rd</sup> place in 2016).
- Five countries who has the most economic freedom as per the index (2019) respectively were;
  - Hong Kong (01)
  - Singapore (02)
  - New Zealand (03)
  - Switzerland (04)
  - Australia (05)

**III. What are the key categories of free goods? (03 marks)**

- a. Non-scarce natural resources Ex;- air
- b. Goods that are produced as a byproduct from another production process Ex;-waste of cardboard or polythene production
- c. Ideas and creative that can be replicated at zero cost Ex;- web page that has no restriction to copy ( However through intellectual property law these free goods can be converted in to economic goods)

(01 mark each to a correct answer)

**IV. There are 3 types of incentive systems used by alternative economic systems. What are those incentive systems and explain them. (03 Marks)**

- Material incentive (1/2 Marks)

This is the incentive that is mainly can be seen in market economies where individual profit maximization becomes the main motivation for suppliers to supply its production.  
(1/2 Marks)

- Coercive incentive (1/2 Marks)

In command economies production is mainly controlled by the authoritative powers. Not only in command economies but also in other mixed economies government authority on taxation, implementation of some of the agreements can be considered as coercive incentive.(1/2 Mark)

- Moral incentive (1/2 Marks)

This is the incentive system that move people on emotional drives such as patriotism, ethnicity, self-dignity, kindness, compassion etc. Ex:- 'country first', 'sacrifice for revolution (1/2 Marks)

V. **'Some of the workers in their working age decides not to seek work since they are fulltime students or housewives. Explain how does this affect to full employment of the economy. (04 Marks)**

- This does not affect the full employment of the economy. (01 Mark)
- When they stop seeking work, those persons become economically inactive and thereby do not get counted in to labour force. (01 marks)
- When full employment is concerned it considers whether all persons who are in the working age and seeking to work are employed or not. (01 Marks)
- When persons are not seeking to work, since they fall out of labour force, it will not get affected to full employment of resources. (01 Marks)

VI. **Technological knowledge can take different forms? Explain (4 marks)**

- Some technological developments are open to everyone. For example after Henry Ford successfully found and used the assembly line, it was followed by all other motor vehicle manufacturers. (01 Mark)
- But some technological knowledge has been converted into property rights, and they cannot be used by everyone. E.g.: Secret recipes (01 Mark)
- Some other technological innovations are kept as private property for a small period of time. For example, when a patented license is issued for medicine, only that company can produce it. But after some time when the patented license expires, other companies can also produce it. (02 Marks)

02.

I. **"Change in purchasing power of consumers may result in a shift of the demand curve as well as a movement of the demand point". Do you agree with this statement and explain this statement.(4 marks)**

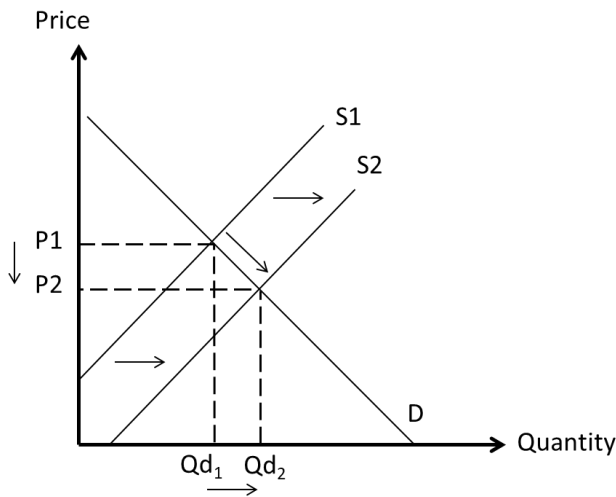
- Yes, agree with the statement.(1/2 mark)
- The purchasing power or the real income shows the amount of goods and services that can be purchased from the consumer income

- The purchasing power of a person's income can be changed in two ways,
  1. Change in the price of the concern good while holding the nominal income constant(1/2 mark)
    - In this situation without changing any other factor including consumer income, the price of the concern good changes.
    - As a result, the real income or the purchasing power of a person's income gets changes. (1/2 Mark)
    - As the demand curve does not get changed but the quantity demand gets changed due to income effect of the price change. (1/2 mark)
    - Thus, a point moves upward or downward along the demand curve without a shift of the curve. (1/2 mark)
  2. Change in the consumer income ( nominal income)(1/2 mark)
    - In this case, the consumer income changes without changing any other factor affecting demand (even the price of the concerned good remain constant).
    - Hence, the purchasing power gets changed and it leads in to a change in demand (Not quantity demand). ( ½ Mark)
    - So, the demand curve will shift either to left or to right with the income change. (1/2 mark)
- Therefore, it can be concluded that according to above mentioned ways change in consumer purchasing power can shift the demand curve as well as will move a point on the demand curve.

**II. "Increase in the supply of a good may causes an increase in the quantity demand of the same good". Can this statement be true? Explain your answer using an appropriate diagram. (4 marks)**

- Yes, this statement can be true. (1/2 mark)
- When the supply of good rises, supply curve shifts to right. ( As it is shown on the diagram S1 shifts to S2) (1/2 mark)

- When supply curve shifts to right if demand curve remain constant, equilibrium quantity in the market will get increased. ( As it is shown on the diagram, quantity changes from  $Q_1$  to  $Q_2$ ) (1/2 mark)
- As a result, market price may falls from  $P_1$  to  $P_2$  ( as it is shown on the diagram) and equilibrium point will move downwards along the demand curve. In other words, it creates an increase in quantity demand. (1/2 mark)
- This can be shown by the diagram below, (Correct diagram ; 2 mark)



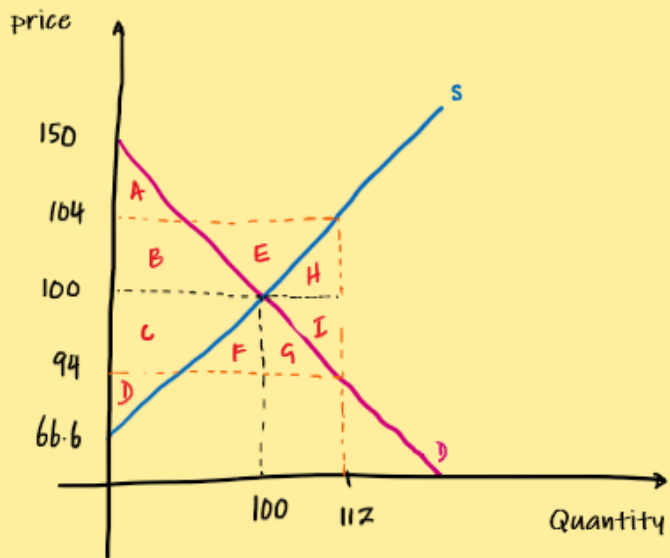
### III. Distinguish between individual demand curve and market demand curve. (2 marks)

- Individual demand curve is a simple graph showing the various amounts of a product an individual consumer is willing and able to purchase at each price in a series of possible prices during a specified period of time, all other things remain unchanged. (01 Marks)
- Market demand curve is a graph showing the total quantities of a product all consumers are willing and able to purchase at each price during a specified period of time, all other things remain unchanged. (01 Marks)

[Alternative answer: The market demand curve is the horizontal sum of the individual demand curves and is formed by adding the quantities demanded by each individual at each price.]

### IV.

### Working I



## Working II

### After Subsidy

$$Q_s = -200 + 3(p+10)$$

$$Q_s = -200 + 3p + 30$$

$$Q_s = -170 + 3p$$

### Equilibrium After subsidy

$$Q_d = Q_s$$

$$300 - 2p = -170 + 3p$$

$$300 + 170 = 3p + 2p$$

$$\frac{470}{5} = \frac{5p}{5}$$

$$94 = p$$

$$\text{If } p = 94$$

$$Q_d = 300 - 2p$$

$$Q_d = 300 - 2(94)$$

$$Q_d = 300 - 188$$

$$Q_d = 112$$

$$\begin{aligned}
 \text{(a) Consumer Surplus (After subsidy)} &= \frac{1}{2} \times [150 - 94] \times 112 \\
 A + B + C + F + G &= \underline{\text{Rs } 3136 \text{ (02 marks)}}
 \end{aligned}$$

$$\begin{aligned}
 \text{(b) Producer Surplus (After subsidy)} &= \frac{1}{2} \times [104 - 66.6] \times 112 \\
 B + C + D + E &= \underline{\underline{\text{Rs } 2094.4 \text{ (02 marks)}}}
 \end{aligned}$$

$$\begin{aligned}
 \text{(c) Dead weight Loss} &= \frac{1}{2} \times [112 - 100] \times 10 \\
 H + I &= \underline{\text{Rs } 60 \text{ (02 marks)}}
 \end{aligned}$$

$$\begin{aligned}
 \text{(d) Subsidy benefit on Consumer} &= [104 - 100] \times 112 \\
 B + E + H &= \underline{\text{Rs } 448 \text{ (02 marks)}}
 \end{aligned}$$

$$\begin{aligned}
 \text{(E) Subsidy benefit on producer} &= [100 - 94] \times 112 \\
 C + F + G &= \underline{\text{Rs } 672 \text{ (02 marks)}}
 \end{aligned}$$

3.

- I. What is meant by 'product differentiation' and what are the main ways product differentiation can be carried out in monopolistic competition? (03 Marks)



- Product differentiation is the situation where all suppliers try to present their product offerings distinguishing from other suppliers and offer them as a distinctive product. (01 Marks)
- In other words, even though product offerings of two suppliers become close substitutes but due to product differentiation supplier try to create a demarcation between the products and avoid they being perfect substitutes (1/2 Mark)  
Ex:- Soap, toothpaste
- Mainly product differentiation can be carried out through:
  - a. Quality of the goods (1/2 Marks)
  - b. Price of the good (1/2 Mark)
  - c. Marketing of the good (1/2 Mark)

**Special Note:-**

- Quality of the product includes factors such as nature of the product, shape of the product, durability of the product, special customer services etc.
- Marketing of the good includes factors such as advertising, packaging, promotions etc.

**II. How does the following affect the Short run marginal cost (MC), total fixed cost (TFC) and average total cost (ATC)?(6 marks)**

	MC	TFC	ATC
a. Increase in wage rates	Increase (1/2 Marks)	No Impact (1/2 Marks)	Increase (1/2 Marks)
b. Decrease in property taxes	No Impact (1/2 Marks)	Decrease (1/2 Marks)	Decrease (1/2 Marks)
c. Increase in supply prices of new capital goods	No Impact (1/2 Marks)	Increase (1/2 Marks)	Increase (1/2 Marks)
d. Increase in fuel prices	Increase (1/2 Marks)	No Impact (1/2 Marks)	Increase (1/2 Marks)

**III. What are the main reasons that cause decreasing returns to scale? (03 Marks)**

- Decay of resources.
- Tension and stress.
- Management and coordination issues.

**IV. 'Perfect knowledge about the market is one of the main factors contributing to create a perfect competition and the absence of perfect knowledge creates market imperfections'.**

**a. What is meant by perfect knowledge? ( 02 Marks)**

- This is one of the conditions in the perfect competitive market that describes all entities in a market (producers & consumers) take their decisions with perfect understanding and knowledge about the market. (2 marks)
- In other words, this is the condition that describes information such as demand and supply condition of the market, prices, profit contribution, production cost and technology are freely able to all the firms in the industry and the firms who are willing to enter in the industry. Further, they can obtain this information without incurring any cost.

**b. Explain how the absence of perfect knowledge makes market imperfect (02 Marks)**

- Absence of perfect knowledge can make markets imperfect in following methods:
  - a. If firms have no perfect knowledge there can have differences in market prices.
  - b. Further, due to the fact that some of the firms do not know whether they can make profits, they might not enter in the industry.
  - c. When there is imperfect knowledge some of the firm will benefit than the other firms and it makes such firms the make an impact to the market.

(Any of the 2 points 2 marks)

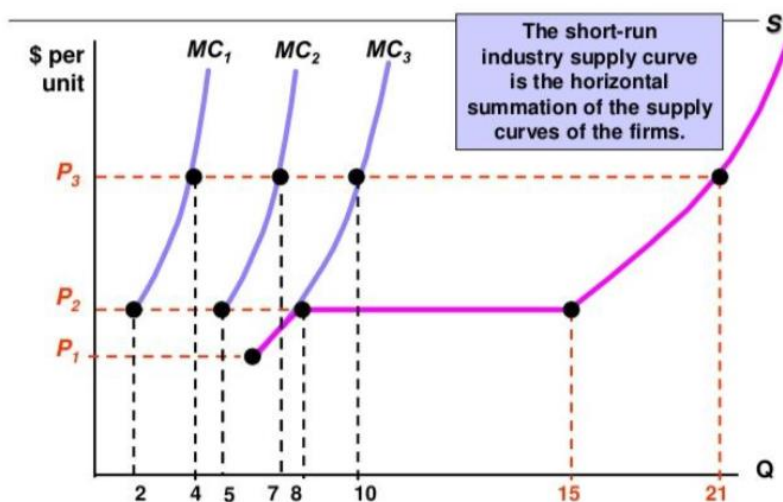
V. Discuss whether there is a relationship between the marginal cost curve of the firm and the supply curve of the industry to which it belongs. (04 marks)

Firm's Supply Curve

- Perfectly competitive firm supplies a quantity at which either it 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 minimum variable cost point.

Industry 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 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 aggregates, industry supply curve can be obtained.



4.

**I. How does aggregate demand determine the level of income? (03 marks)**

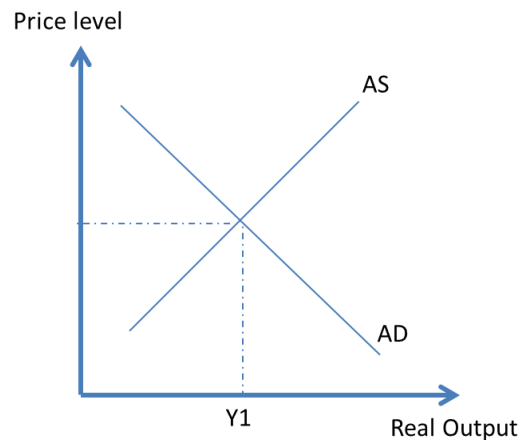
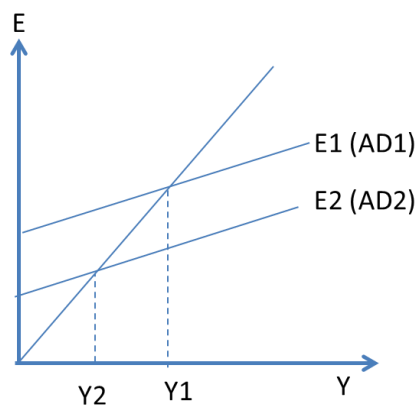
a) In a given period when an aggregate demand equals to the real output (aggregate supply) equilibrium income level is determined. ( $Y=E$ ) (01 mark)

b) if aggregate demand exceeds aggregate supply, real output gets expanded. This is a disequilibrium situation. (1/2 mark)

c) if aggregate supply exceeds aggregate demand, real output gets contracted. This is a disequilibrium situation. (1/2 mark)

Note: - If only graphs are provided no marks (01 mark for the diagram)

**Alternative diagram**

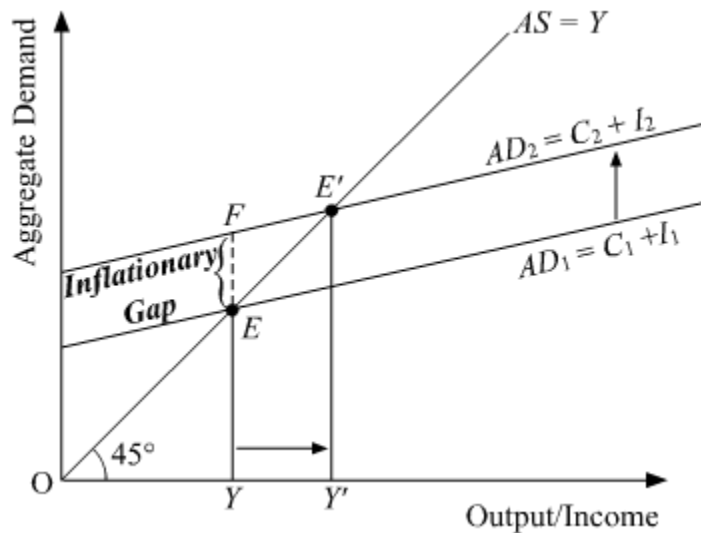


**II. Distinguish between “inflationary gap” and “recessionary gap” (04 marks)**

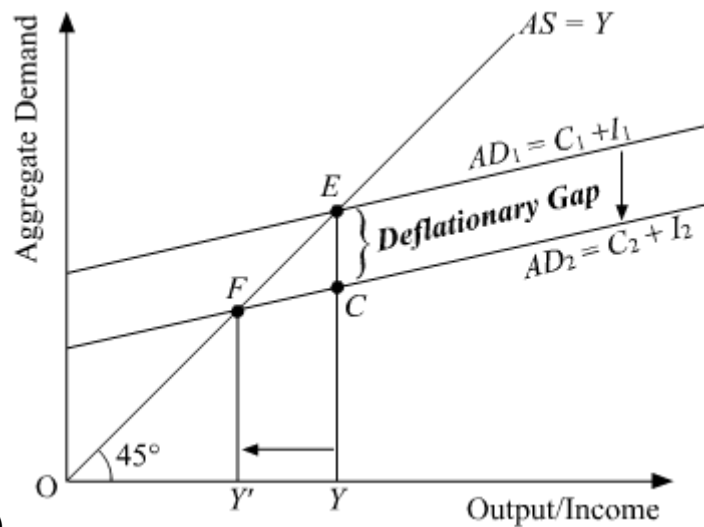
- An inflationary gap is a macroeconomic condition that describes the distance between the current level of real gross domestic product (GDP) and full employment (long run equilibrium) real GDP when current level of real output is greater than full employment level of output. (1 mark)
- As a result of the inflationary gap price level of the economy rises. This consequence takes place as an effect of inability of business firms to increase their real output within the rise in aggregate demand. This creates demand-pull inflation. Hence even though nominal GDP rises real GDP remains unchanged. (1/2 mark)
- A recessionary gap (deflationary gap) is a macroeconomic condition that describes the distance between the current level of real gross domestic product (GDP) and full

employment (long run equilibrium) real GDP when current level of real output is lower than full employment level of output. (1 mark)

- During a recessionary gap there is a deficiency in aggregate demand to reach full employment. As a result it creates recessionary effect and unemployment in the economy. (1/2 mark)



Note; -  $Y'$  is the current output and  $Y$  is the full employment output.



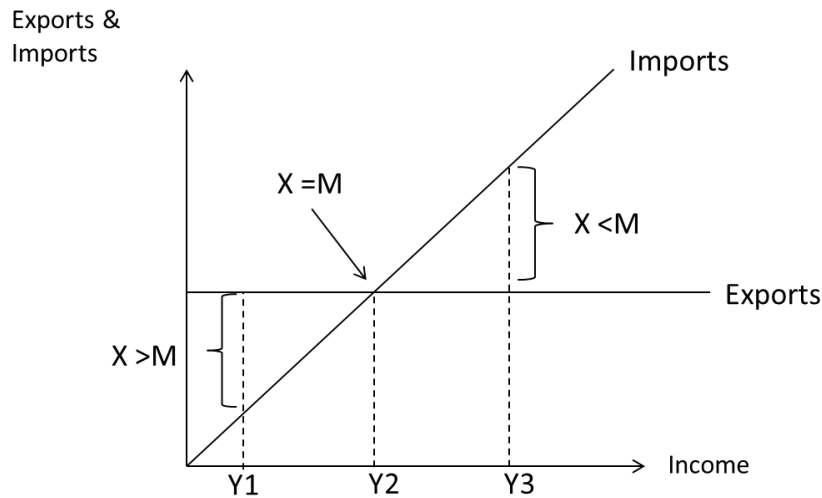
(1/2 marks)

Note; -  $Y'$  is the current output and  $Y$  is the full employment output.

(1/2 marks)

**Important:** - if business cycle diagram is used to explain the concepts no marks.

- III. 'Up to a particular level of national income net exports become positive and there after net exports become negative'. Explain this idea using an appropriate diagram.(04 marks)



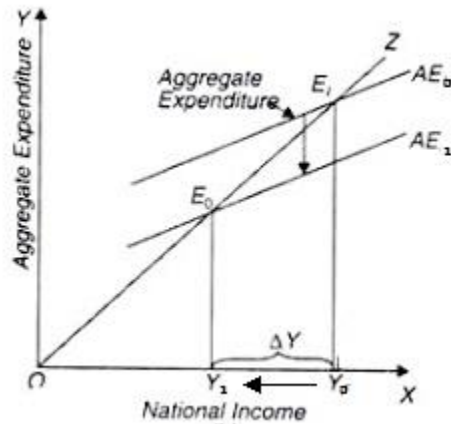
(02 marks for the correct diagram)

- Up to Y2 level of income exports are greater than imports and there by net exports becomes a positive value.(01 Mark)
  - However after Y2 level of income imports are greater than exports and thereby net exports becomes a negative value.(01 Mark)
- IV. Why is 'investment' considered as an 'injection' whereas 'saving' is considered a 'leakage'? ( 03 marks)

- Leakages are the factor income (received by factor owners) those will leak-out (opt-out) from the main circular flow of income without being a part of the expenditure that gets circular in the circular flow. (1 mark)
- 'Savings' are getting leaked out from the main circular flow of income without being a part of consumption expenditure that will flow back again in the main circular flow of income. Thus, 'saving' is considered a 'leakage'.(1 mark)
- Injections are additional money inflows injected to the main circular flow of income by any other economic agent except households to purchase output produced by domestic business firms. (1 mark)
- Investments are money inflow made by business firms to purchase capital goods. Therefore it will be an injection to main circular flow of income. (1 mark)

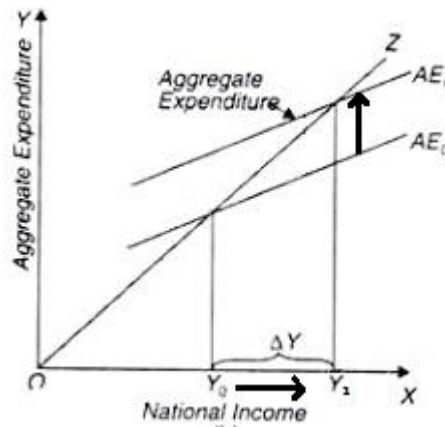
V. Explain the effect on Keynesian cross due to following incidences.

- a) Increase in general price level when money supply is constant (1 mark)



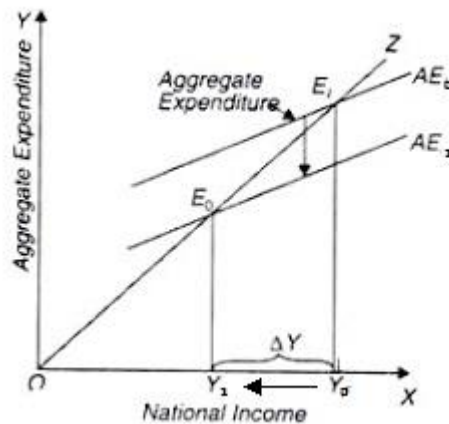
Increase in general price level will increase the demand for money under both transactionary and precautionary motive. When money supply is constant and demand for money increases, it will lead to an excess demand situation, which will cause an increase in interest rates. When interest rates are increased, investment demand will decrease, and as a result planned aggregate expenditure will decrease, causing the AE curve to shift downwards, leading to a decrease in national income.

- b) Increase in government purchases(1 mark)



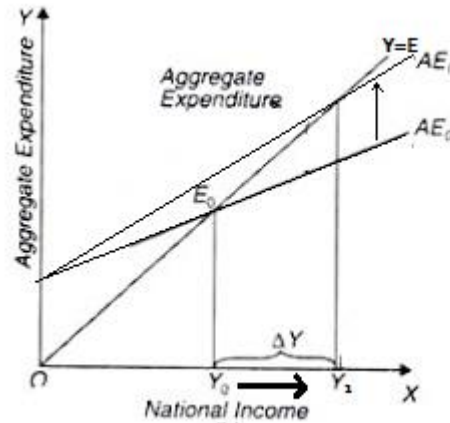
Increase in government expenditure will cause an increase in autonomous expenditure, as a result aggregate expenditure will increase, causing the AE curve to shift upwards, leading to an increase in national income.

- c) Increase in indirect taxes by the government(1 mark)



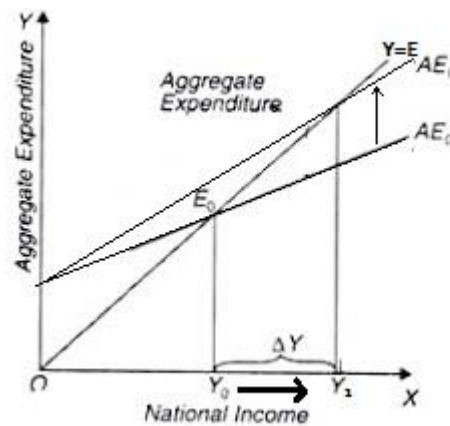
Increase in indirect taxes will cause a decrease in autonomous expenditure, as a result aggregate expenditure will decrease, causing the AE curve to shift downwards, leading to a decrease in national income.

- d) Increase in Marginal Propensity to Consume(1 mark)



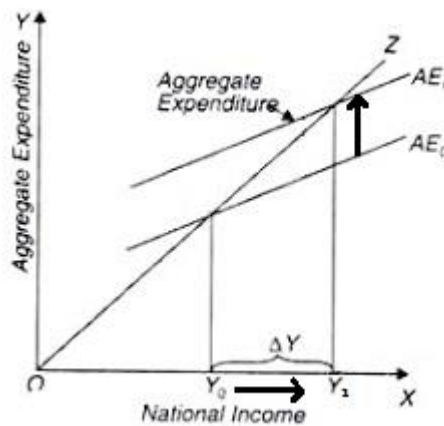
Increase in marginal propensity to consume will cause the AE curve to shift unparallel. When MPC is increased,, it will increase consumption of the economy, , leading to an increase in national income.

e) Decrease in interest rate(1 mark)



When interest rates are decreased investment demand will increase, and as a result planned aggregate expenditure will increase, causing the AE curve to shift upwards, leading to an increase in national income.

f) Increase in income of rest of the world(1 mark)



Increase in income of rest of the world will lead to an increase in exports of a country which will cause an increase in autonomous expenditure, as a result aggregate expenditure will increase, causing the AE curve to shift upwards leading to an increase in national



05.

**I. What is bit coin? What are the unique characteristics of it. (3 marks)**

- Bit coin is a type of crypto currency, which is only present in the cyber platform. It has no physical existence. (01 mark)
  - No single person, authority or organization has control over it.
  - Cannot be created unlimitedly.
  - Created by solving mathematical sums using computer software.

(any of the two characteristics 02 marks)

**II. What are the assumptions used in the equation of exchange? What are the reasons behind those assumptions? (3 marks)**

1. The velocity of money remains constant (1/2 Mark)

The velocity of money is assumed to be held constant, as holding currency balances is decided by the fixed habits of the general public. (1 Mark)

2. The real output remains constant (1/2 Mark)

The real output is assumed to be held constant, as the economy has achieved full employment. (1 Mark)

**III. "Changes in the general price level has a direct impact on the standard of living of people." Do you agree? Explain. (3 marks)**

- Yes, I agree (1/2 mark)
- Price stability (maintain the general price level of a country at a stable level) is one of the important macroeconomic objectives.
- It is because a change in general price level affects purchasing power of money directly. (1/2 marks)
- A decrease in general price level will lead to an increase in purchasing power of money while an increase in general price level will lead to a decrease in purchasing power of money. (1 mark)
- Thereby the change in general price level has a direct impact on the standard of living of people, as it affects the purchasing power(internal value) of money. (1 marks)
- Moreover, identifying trends in general price level will be important in compiling economic policies.

**IV. "When the policy makers are unable to identify the natural rate of unemployment accurately, it will lead to stagflation." Do you agree? Explain. (3 marks)**

- Yes, I agree (½ Marks)
- When the policy makers are unable to identify the natural rate of unemployment accurately, they tend to believe that unemployment can be reduced without creating inflation and implement expansionary monetary and fiscal policies.(1 mark)
- As a result, price level will rise, leading to a rise in future inflation expectations. ( ½ Marks)
- As a result of rise in future inflation expectations, nominal income will increase which will lead to an increase in unemployment. ( ½ Marks)
- Once again, unemployment will reach to its natural rate, where inflation rate would be higher than it was before. ( ½ Marks)

**V. What are the reasons for differences between interest rates? Explain. (04 Marks)**

- Level of risk  
Depending on the level of risk associated with the repayment of the loan, interest rates may differ. When there is a higher risk, the interest rate will also be high. (1 mark)
- Maturity Period  
Depending on the time period of the loan the interest rates may differ. Usually long term loans have a higher interest rate than short term loans. It is because the creditor has a higher opportunity cost of providing funds in the long-term. (1 mark)
- Administration Cost  
Depending on the administrative costs associated with providing loans the interest rates may differ. For example there is a clear difference in the administrative costs between granting a loan to a small farmer and a large company. When granting loan to a large company there is a low administrative cost compared to a small farmer. Thereby, the interest rate will be high for small loans. (1 mark)
- Imperfections in market  
The degree of competition will also affect interest rates. When there is a high degree of competition interest rates will be low. In a market where monopoly conditions exist, interest rates will be high. (1 mark)

VI. **Distinguish between quantitative and qualitative credit control methods of the Central Bank of Sri Lanka. (4 marks)**

- The credit control methods used to regulate the volume and cost of credit in the entire economy are called quantitative credit control methods. They are nondiscriminatory in nature and affect the entire economy. (01 marks)
- Types of quantitative methods include policy interest rates (i.e. standing deposit facility rate, standing lending facility rate, the Bank Rate), open market operations and statutory reserve requirement. (01 marks)
- Qualitative credit control methods are used to regulate the flow and direction of credit will certain selective sections of the economy. They are discriminatory in nature. (01 Mark)
- Types of qualitative methods include quantitative restrictions on credit, ceilings on interest rates, refinance facilities, imposing margin requirements, loan to value ratios, moral suasion etc. (01 marks)

06.

I. **'Common resources are always getting over consumed'. Do you agree with this statement? Explain your answer with relevant examples. (04 marks)**

- Agree with the statement (01 Mark)
- Two of the main characteristics of the common resource are consumption cannot be restricted ( non-excludability), however there is a rivalry in consumption (01 marks)
- Since no one can be restricted in in their consumption (or level of consumption), usage of common resources cannot be controlled. As a result most of the time common resources are getting over consumed. (01 mark)
- For example when all famers use a public pastures (grass land) to feed their herds of cattle, public pastures decay fast and it will come in to a situation where no famer can no longer use the pasture. This is also known as 'tragedy of commons'. This situation takes place since no former cannot be excluded from public pasture or cannot restrict the usage of a famer.

This same situation is common among fisherman when they use fish resource.

Atmosphere is another common resource that can be used as an example to explain the above.

( any of the appropriate example 01 mark)

**II. 'Market failure takes place due to inefficiency of resource allocation, inequality of resource allocation and macro-economic instability. Explain each of the concepts and show how market failure takes place due to each of these situations. (04 marks)**

- Inefficiency of resource allocation takes place due to the fact that all markets do not become perfectly competitive markets. (1/2 Marks)
- Most efficient resource allocation would only take place if all market of the economy becomes perfectly elastic and would be able to produce goods and services combinations desired by consumers at the lowest possible resource cost. When markets have imperfect competition, inefficiency of resource allocation would take place (1/2 Marks)
- Due to inefficiency of resource allocation following situations would takes place and it will lead in to market failure:
  - a. Non provision of public goods
  - b. Under provision of demerit goods
  - c. Existence of demerit goods
  - d. Missing markets ( For some goods markets are not available)
  - e. Factor immobility

( any of the 03 points ½ mark)

- Inequality of resource allocation takes place when market economy distributes resources unequally among households due to the disparity of income distribution. (1/2 Marks)
- In a market economy household income is dependent on many factors such as amount of labour scarified, level of education, hereditary properties, factor prices, personal fortune etc. Thereby, even though market economy is fully efficient in production still there can have many disparities in between household. (1/2 Marks)  
Ex;- Amount of milk used by a child in a poor household is equals to the milk consumed by a dog in a rich household
- Inequality of resource allocation may lead to political and social unrest of the economy and that will lead in to market failure. (1/2 Marks)

- Macro-economic instability takes place due to the volatility that creates in the economy. This is often shown by the business cycle. (1/2 Marks)
- Due these economic volatility unemployment, inflation etc would vary from time to time and it may lead in to market failure. (1/2 Marks)

**III. Explain how following events creates externalities in a market economy:**

**a. Many schooling age students gets education (01 Mark)**

- This creates positive externalities. (1/2 Marks)
- When the person gets his education, he can contribute to the growth of the economy and it will help to uplift many other lives. (1/2 Mark)

**b. Too many vehicles on the road and creates severe traffic congestion(01 Mark)**

- This creates negative externalities. (1/2 Marks)
- When there are too many vehicles on the road it leads in to environmental pollution, road accidents, time wastage etc. Thereby, not only the persons who use vehicles but also the pedestrians and the overall economy may suffer. (1/2 Mark)

**c. Provide vocational training to unemployed workers. (01 Mark)**

- This creates positive externalities of consumption.(1/2 Marks)
- When an unemployed person gets vocational training his or her employability rises. As a result he/she can contribute to the economic development and the burden on public finance to provide unemployment benefits to these persons may go down. Thus, not only the unemployed worker but also the overall economy may benefit through this vocational training (1/2 Mark)

**d. Not having proper waste disposal mechanism(01 Mark)**

- This creates negative externalities.(1/2 Marks)
- When there is no proper waste disposal mechanism it will create many social and health problems such as dengue, malaria etc. Thereby, it may create a problem to overall society not only to the persons who do not have a proper place to dispose waste. (1/2 Mark)

**e. Broadcast loud music though loud speakers and create public nuisance (01 Mark)**

- This creates negative externalities.(1/2 Marks)

- When loud music is broadcasted, it creates nuisance to many persons who are not involved. Ex:- Awurudu Uthsawaya. Thereby, it creases uneasiness among many persons (1/2 Mark)

**f. Spray words and make public palaces unpleasant (01 Mark)**

- This creates negative externalities.(1/2 Marks)
- When public places become unpleasant it affects many persons who use these public places and it damages image of the country when foreigners visit the country. Further, in order to clean up those places public funds needed to be used. Thus, it negatively impacts overall economy (1/2 Mark)

**g. Provide vaccinations to avoid communicable diseases. (01 Mark)**

- This creates positive externalities.(1/2 Marks)
- Communicable diseases are the diseases those get infected from one person to another. Thereby when one person gets infected there is a chance that unrelated persons also getting infected. Thus preventing such communicable disease provide benefits to the entire society. (1/2 Mark)

**h. Expenditure on research and development (01 Mark)**

- This creates positive externalities. (1/2 Marks)
- Research and development expenditure helps to develop new technologies and innovations. Thus, it helps for the development of the economy which contribute to the betterment of many persons (1/2 Mark)

**IV. Explain how tax principle of "ability to pay" and "principle of benefit" contradicts with each other? (4 marks)**

- Principle of benefit refers to that the taxes should be paid to the government according to the amount of services received by the government. (01 mark)
- Principle of ability to pay refers to that the taxes should be charged according to a person's ability to pay taxes. (01 mark)
- It is conflicting as people with less income rely more on government to fulfill their needs whereas people with a higher ability do not rely much on the govt. for fulfilling their needs. (01 mark)
- There by more benefit is passed on to people with lower ability when services are provided by the government. (01 mark)

- Thereby how tax principle of "ability to pay" and "principle of benefit" contradicts with each other.

07.

**I. Explain the economic factors, which might determine patterns of trade between countries. (4 marks)**

(01 mark each for any correct answer and altogether 04 marks)

- Differences in factor endowment among countries
- Difference in returns to scale / economies of scale among countries (Mainly due to technology)
- Geographical location & other geographical factors
- Product differentiation in different countries (differences in specialization & knowledge)
- Differences in preferences in different countries.
- Differences in technology and innovation in different countries.
- Advantages of specialization
- Government policies

**II. How would the double entry of the following transactions be recorded in balance of payment? (6 marks)**

**a. A Malaysian investor buying shares worth of \$20 million from the Colombo Stock Exchange (01 mark)**

- Credit – Financial Account (Portfolio investment)(1/2 Marks)
- Debit – Financial Account (Currency and Deposit)(1/2 Marks)

**b. An American tourist exchanging 600 US Dollars from BOC and obtaining an equivalent amount in Sri Lankan rupees (01 mark)**

- Credit – Financial Account (Financial derivatives and other investments) (1/2 Marks)
- Debit – Financial Account (Currency and Deposit) (1/2 Marks)

**c. Remittances sent to parents in Sri Lanka by Sri Lankans who work in Middle East. (01 mark)**

- Credit – Current Account (Secondary income account 1/2 Marks)
- Debit – Financial Account (Currency and Deposit) (1/2 Marks)

**d. Repayment of loan installment of \$2500 million and interest payment of \$225 million, from the loan which was obtained to construct the central highway. (01 mark)**

- Credit – Financial Account (Currency and Deposit - \$2775) (1/2 Marks)
- Debit – Financial Account (Financial derivatives and other investments –loans - \$2500) (1/4 Marks)
- Debit – Current Account (Primary income account - \$225) (1/4 Marks)

**e. A Sri Lankan bank receiving \$120 million by selling securities in a foreign financial market . (01 mark)**

- Credit – Financial Account (Portfolio investment)(1/2 Marks)
- Debit – Financial Account (Currency and Deposit)(1/2 Marks)

**f. Central bank of Sri Lanka obtaining a loan of \$200 million from the International Monetary Fund (01 mark)**

- Credit – Financial Account (Financial derivatives and other investments –loans) 1/2 Marks)
- Debit – Financial Account (Currency and Deposit)(1/2 Marks)

**g. A Sri Lankan Publishing company obtaining publishing rights by paying \$7500, to translate and publish one of the bestselling books (01 mark)**

- Credit – Financial Account (Currency and Deposit)(1/2 Marks)
- Debit – Capital Account (1/2 Marks)

**III. Explain how a significant rise in the general price level will affect the current account of the balance of payments of an economy. (4 marks)**

- If general price level rises (inflation), local prices of the products those are exported will go up. (1/2 Marks)
- As a result, quantity that foreign importers can purchase would be lesser for the same amount of foreign currency payment by them (prior to the inflation).In other words local product exports will be more expensive for the foreign importers. (1/2 Marks)
- Thus, If local exports have elastic demand then, local exports will get reduced when price level rises. (1/2 Marks)
- On the other hand with the inflation when local prices of locally produced products rise, for locals, imported products become less expensive. (1/2 Marks)

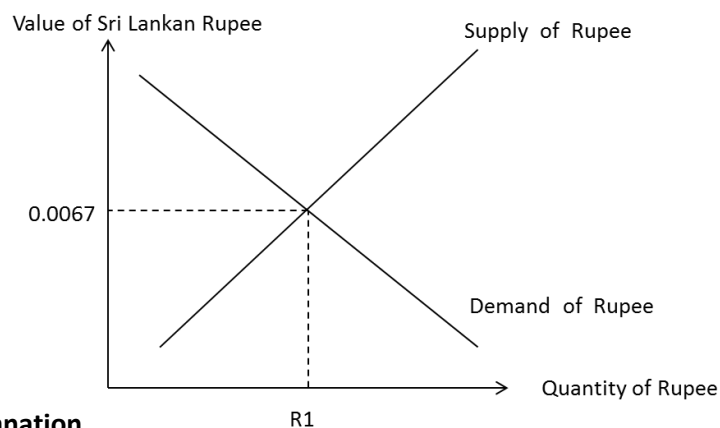


- And thereby, if local imports have elastic demand then, local imports will get increased when price level rises. (1/2 Marks)
- This will make an immediate unfavorable impact on trade balance and balance of payment. (1/2 Marks)
- Further, When import demand rises and export demand falls for local currency demand of foreign currency falls ( due to the reduction in exports) and supply of foreign currency rise ( due to the increase in imports). (1/2 Marks)
- This can lead in to a decrease in external value of local currency. (Local currency gets depreciated). Thereby, it can create a long term negative impact on balance of payment. (1/2 Marks)

**IV. Draw an appropriate diagram to show the determination of the external value of Sri Lankan Rupee in terms of US dollars under a floating exchange rate system. Explain why the demand curve is downward sloping and the supply curve is upward sloping in this foreign exchange market. (03 marks)**

(Either of the graphs 01 marks)

**Graph**



**Explanation**

- Value of the rupee in terms of dollars is determined by the forex market.

**Demand**

- In the graph demand curve represents how much of dollars are demanding to be exchanged for rupees.
- Thus, it represents demand of export buyers and investors (Capital inflows). (1/2 marks)
- When rupee is cheaper against the dollar (rupee value is low), quantity demand for rupee gets increased (encourages exchanging dollars for rupees since higher amount of rupees

can be obtained for one dollar). Further, if rupee is expensive against the dollar (rupee value is high); quantity demand for rupee gets decreased (discourages exchanging dollars for rupees since fewer amounts of rupees can be obtained for one dollar). (1/2 marks)

- Therefore demand curve is a down ward sloping curve that represents negative relationship between price and quantity of rupee.

### **Supply**

- In the graph supply curve represents how much of rupees are supplying to be exchanged for dollars. (1/2 marks)
- Thus, it represents supply of importers and Capital outflows. (1/2 marks)
- When dollar is cheaper against the rupee (rupee value is high), quantity supply of rupee gets increased (demand more dollars since dollars can be exchanged for less amount of rupees). Further, if dollar is expensive against the rupee (rupee value is low); quantity supply for rupee gets decreased. (demand less dollars since to purchase a dollar higher amount of rupees should be paid)
- Therefore supply curve is an upward sloping curve that represents direct relationship between price and quantity of rupee.

### **V. Name the 5 main components of foreign reserve assets. (2 marks)**

- a. Monetary Gold
- b. Special Drawing Rights (SDR) of International Monetary Fund
- c. Reserve Tranche in International Monetary Fund
- d. Foreign Currency Balances
- e. Other Equity items

(5, 4 or 3 correct answers→2 marks, 2 correct answers→1 mark)