

1.

i) **Discuss whether the imposition of maximum prices can improve the problem of scarce resources. (4 marks)**

- The reason for maximum prices is to ensure that lower income consumers can afford to purchase the relevant goods and services. The imposition of maximum prices will only be effective if the maximum price is imposed below the equilibrium price.
- The imposition of a maximum price is only a temporary solution for the problem of income distribution.
- Scarcity is a universal problem which deals with the limitation of economic resources in comparison to the unlimited human wants. Thus, a maximum price will not eliminate the issue of scarcity.
- Further, a maximum price will increase the shortage in the market due to the excess demand created when selling price is reduced.

Commented [m1]: Cambridge – 22 March 2019

ii)

a) **What is meant by the term “division of labour”? (2 marks)**

- The production of a good or service is broken down into a large number of separate and simple operations. Each worker is responsible for and spends the whole of his or her time carrying out one of these operations. Thus, in many industries, the finished product is the result of the combined efforts of many hundreds of specialized workers. This technique of breaking down production into a large number of specialized tasks is described as the division of labour.

Commented [m2]: A/L Past paper - 2006

b) **Explain how division of labour may reduce costs of production and increase competitiveness. (6 marks)**

- “Practice makes perfect” – When a worker concentrates on a task which requires no more than a few relatively simple movements, he or she develops the ability to do work with great speed and dexterity.
- An important advantage of the division of labour is that it makes it possible to mechanize the production process. When production is subdivided into many simple operations, it is not a too difficult task to devise a machine for each of these operations. Even today if there is no division of labour adapted. It becomes possible to use a whole range of powered tools and machines such as saws planes, drills, lathes, polishers and so on.
- When a worker is responsible for several different operations, workers will have a set of tools for each of the different tasks. For a large part of the time therefore much of the equipment will be lying idle. When work is specialized, each worker only needs one set of tools and these will be in constant use. Thereby, it reduces the fixed costs.
- Since the employees do not move onto various tasks in the process of production, his time is not wasted unnecessarily.

- As the work is broken down into individual tasks, it is likely that new and more efficient techniques will be developed.
- 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.

iii) **What are the differences between 'capital' and 'human capital'? (04 marks)**

- Capital is a produced factor of production. They are real assets. Capital include factories, equipments, stock of raw materials etc.
- Human capital means the stock of competencies, knowledge and social and personality attributes acquired through education and training by individual workers.

Differences

- Human capital has characteristics of both labour and capital.
- Human capital is less tangible than physical capital.
- Unlike investment in other forms of capital, investment in human is tied to a specific person.

iv) **State the disadvantages of a command economy. (4 marks)**

- Societal needs might be ignored.
- No consumer sovereignty and freedom to choose / Freedom is restricted.
- In the absence of private ownership of resources and property, system does not give people the incentive to work hard / the authority might misplace incentives.
- Innovative developments might be hindered to lack of incentives.
- No competition is offered.
- Black markets would explode.
- Coordination and management problem.
- Bureaucracy.
- No competition.
- Government monopoly
- Slow economic growth
- It is difficult to find necessary information to implement a sound planning system.
- Lack of incentives.
- Failure of quality control.
- Environment degradation.
- It is difficult to introduce innovations.

Commented [m3]: Past paper - 2013

Commented [m4]: A/L 2017

2.

i) **Explain how a free market would react if a minimum price which had been set above the equilibrium is removed. (4 marks)**

- The guaranteed minimum price or price floor, set above the equilibrium, would be removed. This would lead to the excess supply disappearing.
- The market would revert to an equilibrium position, leading to a fall in price with and increase in quantity traded.
- There would neither be an excess supply nor an excess demand in the free market: the quantity demanded will increase and the quantity supplied will reduce, so eliminating any excess.
- A market clearing position would be established.
- The impact on the producer revenue will depend on the elasticities of demand and supply.
- Consumer surplus will increase.

Commented [m5]: Cambridge – 21 June 2019

ii) **Explain the use of the concept of income elasticity of demand in a market relation to the different types of goods when consumer income increases. (4 marks)**

- YED is the percentage change in the quantity demanded of a product divided by the percentage change in incomes.
- For a normal good, the YED will be positive for normal goods. In other words, as consumer incomes rise, the demand for products will rise.
- For an inferior good, the YED will be negative for. That is, as consumer incomes rise, the demand for products will fall.
- If there is an increase in consumer income, a market is likely to stock more normal goods and fewer inferior goods.
- Essential goods have a positive YED, but it is rather low, e.g. less than one (inelastic). Hence, even if there is an increase in incomes, it is unlikely to be very much of an effect on the available stocks.

Commented [m6]: Cambridge – 21 June 2019

iii) **Explain the differences between what causes a movement along an aggregate supply curve and a shift in an aggregate supply curve. (4 marks)**

Movement along an AS curve:

- This is caused by a change in the price level.
- NOTE: It could also be caused by a change in the AD curve and there is a movement along an AS curve to restore the equilibrium in the market.

Shift in an AS curve:

- This is caused by any reason other than a change in the price level, e.g. a change in the costs of factors of production, a change in the taxes on firms, a change in the productivity/quality of inputs or a change in the quantity of resources

Commented [m7]: Cambridge – 21 June 2019

- iv) Explain the incidence of a subsidy (subsidy benefit) in a market for essential transport. (4 marks)

- The effect of introducing a subsidy in a market for essential transport will lower the market price increase the demand for the transport.
- The extent of this increase will depend on the price elasticity of demand for transport, as will the incidence of the subsidy.
- This is because the incidence of the subsidy or the eventual distribution of the advantage of a subsidy depends on the relative inelasticity of demand and supply.
- Since the service in discussion is an essential transport demand is likely to be relatively price inelastic. Thus, the higher subsidy benefit would be for the consumers.

Commented [m8]: Cambridge – 21 June 2019

- v) Suppose the market demand function for a certain consumer good is represented by $Q_d = 500 - 10P$. Calculate the arc price elasticity of the demand of this good over the price range of Rs. 20 and Rs. 30. (4 marks)

$$\text{Arc price elasticity of demand} = b \times \frac{P_1 + P_2}{Q_{D1} + Q_{D2}}$$

Working 1 - Q_d at Rs. 20:

$$\begin{aligned} Q_d &= 500 - 10P \\ &= 500 - (10 \times 20) \\ &= 500 - 200 \\ &= 300 \end{aligned}$$

Working 2 - Q_d at Rs. 30

$$\begin{aligned} Q_d &= 500 - 10P \\ &= 500 - (10 \times 30) \\ &= 500 - 300 \\ &= 200 \end{aligned}$$

Commented [m9]: A/L 2020 – MCQ (figures have been changed)

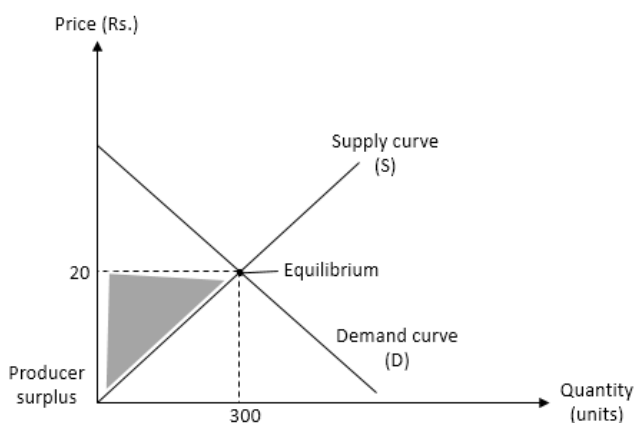
$$\begin{aligned} \text{Arc price elasticity of demand} &= b \times \frac{P_1 + P_2}{Q_{D1} + Q_{D2}} \\ &= -10 \times \frac{20 + 30}{300 + 200} \\ &= -10 \times \frac{50}{500} \\ &= -10 \times 0.1 \\ &= \underline{\underline{-1}} \end{aligned}$$

3.

i) With the help of a diagram illustrate 'producer surplus'. (04 marks)

Commented [m10]: A/L 2003

- Producer surplus is the difference between the market price suppliers get and the price at which suppliers are prepared to supply a certain quantity to the market. When this is calculated for each quantity supplied and aggregated together, total producer surplus can be calculated.



Producer surplus

$$= (\text{Equilibrium price} - \text{Minimum price}) \times \text{Equilibrium quantity} \times \frac{1}{2}$$

$$= (20 - 0) 300 \times \frac{1}{2}$$

$$= \text{Rs. 3000}$$

ii) Explain any four similarities and any four differences between perfect competition and monopolistic competition. (06 marks)

Commented [m11]: A/L 2003

Similarities

- Larger number of firms
- Individual firms are insignificant in the industry
- No abnormal / supernormal profits in the long run
- Free entry and exit
- Pricing and supplying policy of one firm does not affect the other firms in the industry.

Differences

- Product differentiation
 - In perfect competition - Homogenous products
 - In monopolistic competition - Differentiated products
- Firms in monopolistic competition are price makers whereas in perfect competition are price takers.
- Firms in monopolistic competition faces a downward sloping demand curve while firms in perfect competition faces a perfectly elastic demand curve (straight line parallel to the horizontal axis).
- In perfect competition, production is decided in such a way that price is equal to marginal cost whereas in monopolistic competition price will lie above the marginal cost when deciding the equilibrium quantity.

iii) **What is the difference, if any, between 'diminishing returns' and 'decreasing returns to scale'?**
(05 marks)

Diminishing returns

- In the short run, a firm can increase its output by adding units of input to its fixed plant. But the extent to which output increases for additional unit of input is subject to the diminishing returns, also called the law of diminishing marginal product.
- This states that, as successive units of a variable resource are added to a fixed resource, beyond some point, the extra or marginal product that can be attributed to each additional unit of the variable resource will decline.
- The law of diminishing returns is not applicable to the long run because all inputs are variable in the long run.

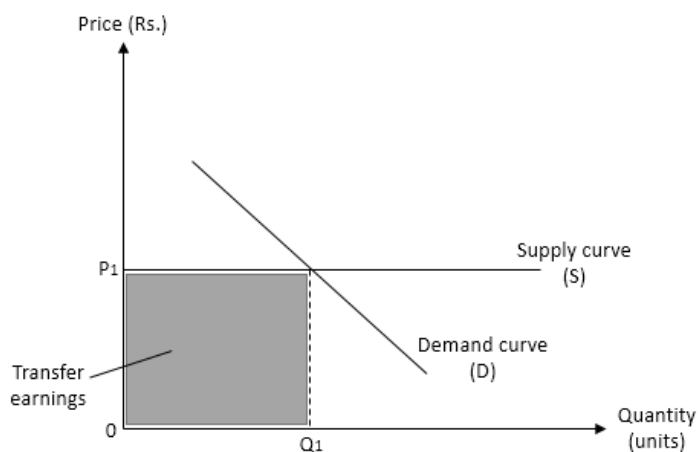
Decreasing returns to scale

- Since the inputs are changed in the long run, the firm changes its scale of production. The concept that applies to the long run is not the diminishing returns but the returns to scale.
- If output increases, by less than that proportional change there are decreasing returns to scale.
- Eg: doubling inputs results in less than double the output

Commented [m12]: A/L 2003

- iv) Under what circumstances does the total earnings of a factor of production contain transfer earnings? Explain your answer using a diagram. (05 marks)

Commented [m13]: A/L 2003



- Transfer earnings is the income which includes the amount sacrificed by the factor owner and salary for the labour employed or interest for capital employed by the factor owner. The income earned over and above this transfer income is called economic rent. The minimum price of a factor is its transfer earnings.
- 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.
- Thereby, total earnings of a factor of production contain transfer earnings when the supply of factor is perfectly elastic.

4.

- i) Explain whether a cheque should be regarded as money. (3 marks)

Commented [m14]: Cambridge – 21 June 2019

- A cheque can be used as a means of payment for goods and services, but it is not the same as money because a cheque is not always acceptable.
- It is an instrument instructing a financial institution to pay a specific amount of money from a particular transactional account held in a person's name with that institution.

- ii) Discuss the effect of an expansionary monetary policy on the economy. (4 marks)

Commented [m15]: Cambridge – 22 Feb 2021

- Expansionary monetary policy is expanding money supply of the economy by reducing interest rates. This will affect to the total output and general price level of the economy.
- An expansionary monetary policy includes reducing interest rates and increasing the money supply.
- It will increase the investment, consumption and aggregate demand
- It will also increase prices.
- It might also lead to a fall in the exchange rate and an increase in net exports.

iii) Suppose that the statutory reserve ratio is 15% and that the bank has cash reserves of Rs. 30 million, loans and investments of Rs. 170 million, and demand deposits of Rs. 200 million.

Commented [m16]: A/L - 2003

a) Assume that this bank operates within a banking system. Can this bank expand its loans? Give reasons for your answer. (03 marks)

- This bank cannot expand the loans.
- This is because this bank does not have excess reserves. The bank has demand deposits amounting to Rs. 200 million and 15% of the deposits should be maintained as reserve which amounts to Rs. 30 million. The bank maintains exactly the same amount as reserves. Therefore, they are not left with any excess reserves.

b) What will be the increase or decrease in the quantum of bank lending if reserve ratio is reduced to 10%. (02 marks)

- When the statutory reserve ratio is reduced upto 10%, the bank should maintain only Rs. 20 million. Currently bank has Rs. 30 million. Therefore, the bank has excess reserves of Rs. 10 million. Bank's lending ability goes upto Rs. 10 million.

iv) Explain how the monetary policy tools were used by the CBSL in response to the COVID 19 pandemic. (8 marks)

Commented [m17]: Model questions - CBSL report – chapter 7

- Reducing policy interest rates
Reducing policy interest rates will enhance the credit flows by lowering real interest rates. This would support domestic investment, production and consumption in the economy.
- Statutory Reserve Ratio (SRR)
Reduction of the SRR to create an expansionary effect in the economy. It enhances liquidity in the domestic money market and help financial institutions, businesses, and individuals that had disruptions in cash flows.
- Reducing bank interest rate (bank rate)
The reduced bank interest rate creates emergency funding in the financial sector at a reduced rate.
- Open Market Operations (OMO) with low short term interest rates
Open Market Operations conducted by the Central Bank guided short term interest rates to remain at low levels while maintaining sufficient liquidity in the money market.
- Provision of concessional loan schemes
Concessional loan schemes were implemented by the Central Bank (under the Saubagya COVID-19 Renaissance Facility) to provide funding to meet working capital requirements of businesses affected by the pandemic. It provided direct relief to businesses, particularly to Micro, Small and Medium scale Enterprises (MSMEs).
- Moral suasion
The Central Bank used moral suasion to persuade commercial banks to reduce market interest rates in line with the monetary policy expectations. It also influenced banks to provide essential liquidity support to pandemic-affected entities, by maintaining constant dialogue with banks.
- Forward guidance

Forward guidance was used as a tool to convince the stakeholders of the economy that the prevailing accommodative monetary policy stance would be maintained until the economy shows strong signs of recovery.

5.

i) **Discuss reasons for and against on why a government should directly intervene in an economy? (4 marks)**

Reasons for:

- Provision of public goods and services.
- Encourage consumption of merit goods.
- To take account of externalities, both positive and negative.
- To ensure high levels of capital expenditure are secured.
- In the case of a natural monopoly, avoiding a wasteful duplication of resources
- Possible strategic argument (i.e. national security)
- Prevention of private sector monopoly power.

Reasons against:

- Lack of incentives for efficient and innovative production
- There may be an absence of competitive pressure
- Political intervention in decision making
- Corruption, bribery and black market

ii) **What are the government policies that can be implemented to influence the free market to improve the allocation of resources? (4 marks)**

- Imposing maximum prices
- Imposing minimum prices
- Imposing indirect taxes
- Granting subsidies
- Carrying out information campaigns etc.
- Imposing new laws or reformation of existing laws

iii) **Discuss whether supply-side policies are likely to be effective in increasing employment in an economy. (4 marks)**

- Privatisation of firms to make them more efficient, leading to an increase in employment.
- Increased spending on education and training to increase labour productivity and employment.
- Lower corporate taxes can leave firms with more money to spend on employing more workers.
- Subsidies may be provided, encouraging firms to increase employees.
- Policies to make the labour market more flexible may lead to an increase in employment.
- Policies to encourage competition, leading to an increase in employment.

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Commented [m19]: Cambridge – 22 Feb 2021

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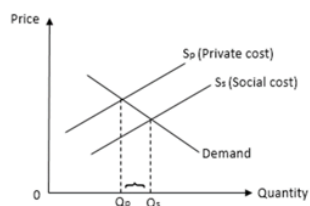
- Financial support to encourage spending on Research & Development, lead to an increase in employment.

iv) Using an appropriate diagram, explain the difference between free market level of output and socially efficient level of output for an economic activity which generates external benefits. (4 marks)

- When production and consumption activities have positive externalities the market output will be lower than the socially optimum market quantity.

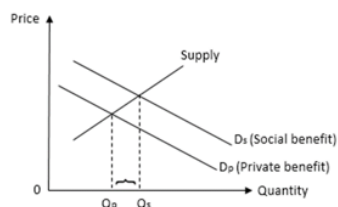
Commented [m21]: A/L - 2004

Positive externality in production



Q_P – Market equilibrium quantity
 Q_S – Socially optimum output

Positive externality in consumption



v) Give recent statistics regarding government revenue. (4 marks)

- Government revenue as a percentage of GDP has decreased over time but hit a considerable low in 2020.

Commented [m22]: Model questions – CBSL report – chapter 6

Gov. revenue as a percentage of GDP	2015	2016	2017	2018	2019	2020
	13.3 %	14.1 %	13.8 %	13.5 %	12.6 %	9.1 %

- The reduction in government revenue in 2020 was mainly due to;
 - The impact of subdued economic activities during the pandemic
 - Tax revision implemented in late 2019 (new government)
 - Tax concessions granted due to the pandemic
- Government revenue consists of mainly 2 components;
 - Tax revenue

- Non-tax revenue

	2019	2020
Tax revenue as a percentage of GDP	11.6 %	8.1 %
Non-tax revenue as a percentage of GDP	1.0 %	1.0 %
Total government revenue as a percentage of GDP	12.6 %	9.1 %

- Tax revenue consists of several tax types;

Tax type	2019	2020
Income tax	2.8 %	1.8 %
VAT	3.0 %	1.6 %
Excise taxes	2.7 %	2.2 %
Import duties	0.7 %	0.8 %
Other taxes	2.4%	1.9%

6.

- i) **What are the consequences of a rise in and fall in the terms of trade? (4 marks)**

- A rise in the terms of trade means that a given quantity of exports can purchase a greater quantity of imports, and the opposite will occur if there is a fall in the terms of trade.
- If the terms of trade rise exports might become uncompetitive however there is a potential rise in living standards.
- If there is a fall in the terms of trade exports become competitive, but inflation might rise as imports become expensive giving rise to cost-push inflation.

Commented [m23]: Cambridge 22 Nov 2020

- ii) **The following hypothetical example depicts the number of calculators and mobile phones that Norway and Sweden can produce with one unit of labour.**

Country	Calculators	Mobile phone
Norway	2	1
Sweden	4	1

Commented [m24]: A/L - 2007

- a) **If each country has 100 units of labour and the country splits its labour force evenly between the two industries, how much of each good can the nations produce individually and jointly? (2 marks)**

- If the labour force is divided evenly, one industry has 50 units of labour. Accordingly the output of both goods in both countries will be as follows;

Country	Calculators	Mobile phone
Norway	2 X 50 = 50	1 X 50 = 50

Sweden	$4 \times 50 = 200$	$1 \times 50 = 50$
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- Therefore, total output by both countries will be;
Calculators = 250 units
Mobile phones = 100 units

b) Which nation had an absolute advantage in calculators and which nation has an absolute advantage in mobile phones? (2 marks)

- Sweden has the absolute advantage in producing calculators.
- No country has the absolute advantage in producing mobile phones.

c) What is the opportunity cost of producing one calculator in each nation? (2 marks)

Country	Opportunity cost of a calculator in terms of mobile phones	Opportunity cost of a mobile phone in terms of calculators
Norway	$1/2 = 0.5$	$2/1 = 2$
Sweden	$1/4 = 0.25$	$4/1 = 4$

d) What is the total or joint output if two nations specialize in the good for which they have a comparative advantage? (2 marks)

- Sweden has the comparative advantage over calculators when Sweden specializes in calculators its total output is $4 \times 400 = 400$.
- Norway has the comparative advantage over mobile phones when Norway specializes in mobile phones its total output is $1 \times 100 = 100$.

iii) Define the following terms and provide two examples for each. (4 marks)

- Customs union:**
 - An agreement between two or more countries to remove trade barriers and reduce or eliminate customs duties on mutual trade.
 - A customs union has a common external tariff against non-member countries.
 - Eg: Central American Common market
Andean Community (CAN)
Caribbean Community (CARICOM)
East African Community (EAC)
South African Customs Community (SACU)

b) Free trade area:

- An agreement between two or more countries that allows the countries to freely trade with each other.
- A free trade area does not have a common external tariff; the countries are allowed to charge whatever tariffs they want against non-member countries.
- Eg: North American Free Trade Area
Asian Free Trade Area

Commented [m25]: Cambridge 21 Nov 2020

iv) **Examine the changes in the Current Account Balance of the Balance Of Payments for the year 2020. (4 marks)**

- The current account comprises of the Trade account, Services account, Primary Income account and Secondary Income account. Thus, the current account balance depends on the balances of these four accounts.
- As a percentage of GDP, the current account deficit was at 1.3 per cent in 2020, compared to 2.2 per cent in 2019.
- The current account deficit narrowed notably in 2020, supported by the significantly reduced trade deficit, increased workers' remittances and relatively low primary income deficit.
- The trade deficit declined in 2020, mainly due to reduced import expenditure following the restrictions imposed on the importation of non-essential goods as well as the eased crude oil prices.
- The surplus in the services account declined sharply as a result of the downturn in the tourism industry and disruptions to air and sea freight transport services.
- However, there was an increase in inflows on account of information technology led business process outsourcing (IT/BPO) related services.
- The deficit in the primary income account contracted with the decline in interest and payments related to dividends.
- Inflows to the secondary income account increased, with higher than expected workers' remittances.
- Thus, these developments led the external current account deficit to narrow in 2020.

Commented [m26]: Model questions from CBSL report (chapter 5)

7.

i) **Define the terms cyclical unemployment and structural unemployment. (4 marks)**

Cyclical unemployment

- Also known as Keynesian unemployment, occurs when there is not enough aggregate demand in the economy to provide jobs for everyone who want to work. In other words it is the unemployment that is attributed to economic contraction. Therefore, it is associated with the business cycle.

Structural unemployment

- Structural unemployment occurs when a labour market is unable to provide jobs for everyone who wants one because there is a mismatch between the skills of the unemployed workers and the skills that are required for the available jobs.

Commented [m27]: Cambridge 42 June 2019

ii) **Outline the limitations of using Gross Domestic Production (GDP) as a measure of a country's living standards. (4 marks)**

- GDP measures the quantitative productions of the country for a given period of time, while measuring living standards is a qualitative concept.
- GDP or per capita GDP can certainly determine the standard of living of people up to a certain extent as the more GDP per capita the better spending capacity, consumption and higher standard of living.
- However, standard of living should be expressed with the following concepts in addition to the GDP per capita;

Commented [m28]: A/L - 2017

- Access to education
- Access to healthcare
- Access to good drinking water
- Peaceful environment
- Freedom of expression
- Good governance
- Freedom of choice
- GDP also will not have accurate information on informal sector, thereby it cannot define the living standards of that sector.
- Standard of living will also be affected by the following factors which are not represented in the concept of GDP;
 - Practical income distribution of the country
 - Unobserved economy
- Thus, it can be concluded that GDP is a limited measure of standard of living of the people.

iii) Discuss briefly on how to improve the agriculture sector and its impact the Sri Lankan economy. (4 marks)

- The country demands more planned and determined efforts to remove bottlenecks in increasing productivity in order to achieve sustained high growth.
- Productivity improvements in the traditional agriculture sector remain a priority in ensuring equitable growth and development.
- Substantially low levels of productivity have adverse effects on incomes of farmers and other workers in the agriculture sector.
- Productivity of the agricultural sector can be increased in the following methods;
 - Increasing economies of scale
 - Promoting modern technology based agriculture
 - Adopting smart farming technologies for efficient usage of resources, such as Good Agricultural Practices (GAP) and Geographic Information Systems (GIS).
 - Efficiently connecting farmers with supply chains.
 - Utilization of nanotechnology for soil improvement and crop disease diagnosis etc.

Commented [m29]: Model questions – CBSL report – chapter 1

iv) Discuss the major factors that hinder the productivity of the industry sector of the Sri Lankan economy and mention how they can be overcome. (4 marks)

- Major factors that hinder productivity improvements in the industry sector include;
 - High energy and labour intensity
 - Barriers for small and medium scale enterprises (SMEs) to establish and develop
 - Obstacles in attracting FDIs
 - Inadequate investment in research and development (R&D)
- These obstacles can be overcome through ;
 - Improving technical competencies of the labour force

Commented [m30]: Model questions – CBSL report – chapter 1

- Establishing industrial zones
- Introducing agglomeration economic policies
- Enhancing innovative capacities

v) **Explain how maintaining macro-economic stability will increase the investor attractiveness of Sri Lanka. (4 marks)**

- Maintaining macroeconomic stability, as well as a low and stable inflation, is an important prerequisite for attracting investors.
- In a volatile environment, investors are unable to predict their future performance and profitability. Thus, are reluctant to initiate investments.
- In the recent years inflation has been maintained in mid-single digits levels.
- However, maintaining macroeconomic stability in terms of the performance of the external and fiscal sectors has been challenging.
- Strong commitment towards strict fiscal discipline is key to improving the country's standing on the global rankings.

Commented [m31]: Model questions – CBSL report – chapter 2