1	II	11	IV	21	I	31	I
2	III	12	III	22	III	32	V
3	I	13	I	23	II	33	II
4	IV	14	V	24	IV	34	III
5	II	15	III	25	II	35	V
6	IV	16	I	26	IV	36	II
7	V	17	I	27	III	37	III
8	V	18	I	28	III	38	I
9	I	19	V	29	IV	39	V
10	IV	20	IV	30	II	40	II

1.

I. Explain what is meant by a production function? And describe the difference between short run production function and long run production function (03 Marks)

- The technical relationship between inputs and output is explained through production function (1/2 Mark)
- Production function expresses from a particular input or input combination, the maximum output that can be obtained or in order to produce a particular level of output, minimum combination of input. (1/2 mark)
- Production function can be expressed as Q = ʃ (K, L) and 'Q' represents quantity, 'K' represents capital goods and 'L' represents amount of labour resources. (1/2 mark)
- In the short run production function it is assumed that output quantity is changed by changing the labour resources while holding capital goods constant. Thus, Short run production function is shown as,

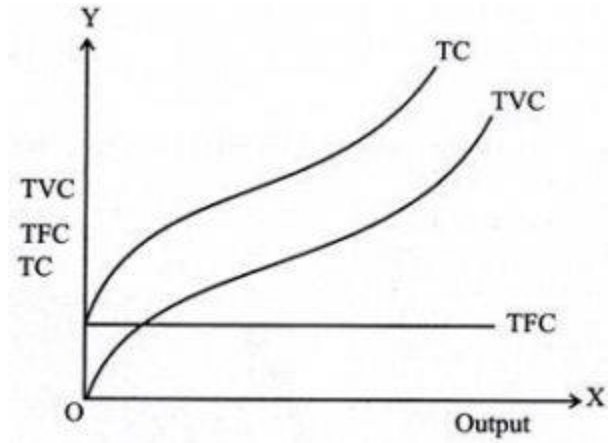
$$\boxed{Q = ʃ\ (\bar{K}, L)}$$

- In the long run production function it is assumed that all input are changed and output quantity is changed with the change of all inputs. Thus, Short run production function is
- shown as, $$\boxed{Q = ʃ\ (K, L)}$$

II. Explain the relationship between total variable cost and total cost? (04 marks)

- Total cost is the summation of Total Fixed Cost and Total Variable Cost.(TC = TFC + TVC)

- TFC, remains unchanged in the short run, and thereby the difference between TC and TVC, which is TFC, represented by the vertical distance between TC and TVC curve also remains unchanged. Hence TC and TVC curves become parallel to each other. (01mark)
- Since TFC, remains unchanged throughout all quantities, change in TC should be due to changes which happen in TVC. Thereby TC curve follows the same shape as TVC curve. (01 mark)
- Both TC and TVC curves rise up at a decreasing rate(due to increasing marginal returns) up to a particular point, and thereafter rises at an increasing rate (due to diminishing marginal returns). (01 mark)



(01 mark for the correct diagram)

III. What is Sunk Cost? Explain (02 marks)

- If a cost that was spent in past which cannot be recovered at present (now), such costs are known as sunk cost.
- For example, if a factory has purchases a machine and it is set up, thereafter there are no alternative benefits of that machine and thereby even if factory is closed that cost cannot be recovered. Thus, such costs are considered as sunk cost and it is irrelevant for the business decision making.

IV. Why firms that are marking zero economic profits are likely to continue in business. (04 marks)

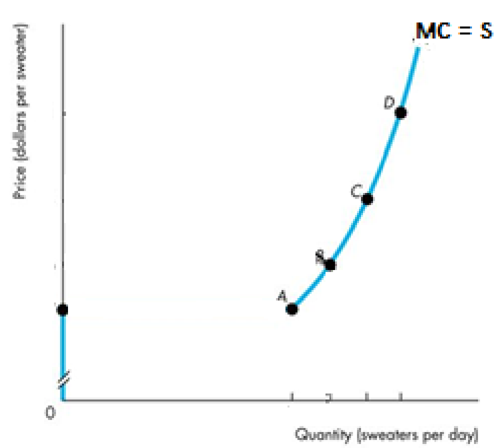
- Zero economic profit is a situation that the firm is able to cover up their total economic cost (both implicit cost & explicit cost) (01 mark)
- In the economic cost normal profit (minimum expected profit)is also included. (01 mark)
- Therefore, when a firm is earning zero economic cost means they are earning the minimum expected profit that they could have earned by being in any other industry as well. (01 mark)
- Thus, firm who is earning zero economic cost is likely to continue in business since they earn what they expected to earn on minimum basis which is equal to the profit that they can earn from any other industry as well.(01 mark)

V. What is the rule of profit maximization? How can this rule be restated when the firm is a price – taker?(3 marks)

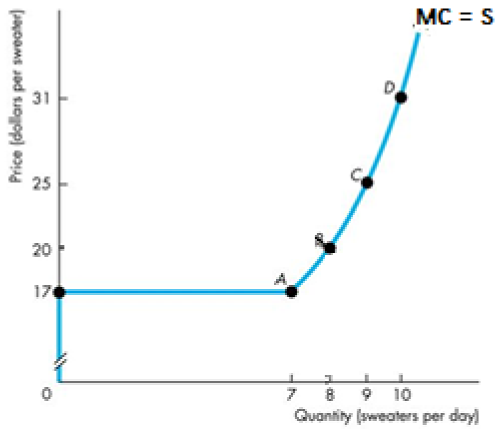
- The profit maximization rule states that a firm maximizes its profits (or minimize its loss), when it produces the level of output where Marginal Cost (MC) equals to Marginal Revenue (MR). (01 Mark)
- In other words, it must produce at a level where MC = MR.
- This criterion takes place in any market when the Marginal Cost curve is rising.
- When the firm is a price taker demand curve faced by a single firm becomes perfectly elastic (horizontal straight-line) and thereby in such firm P = AR= MR takes place. (01 Mark)
- So for this type of firm maximize profit quantity takes place where price (average revenue) equals to marginal cost (P=MC). (01 Mark)

VI. Using an appropriate diagram explain the following situations. (04 marks)

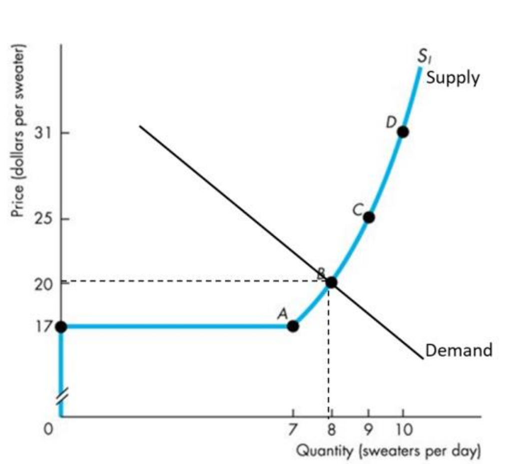
a) Short run supply curve of the individual firm in perfect competition(01 mark)



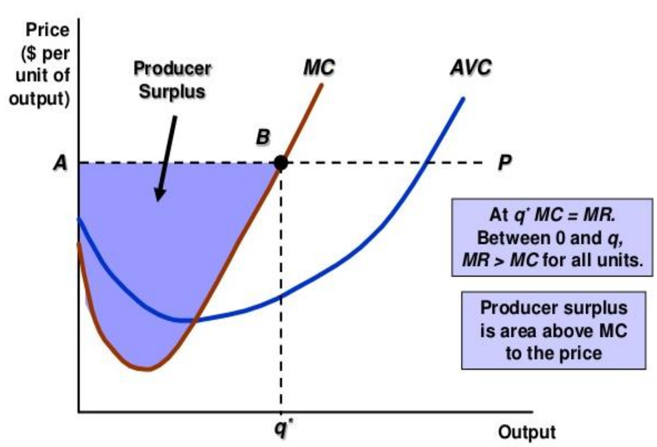
b) Short run industry supply curve of perfect competition market(01 mark)

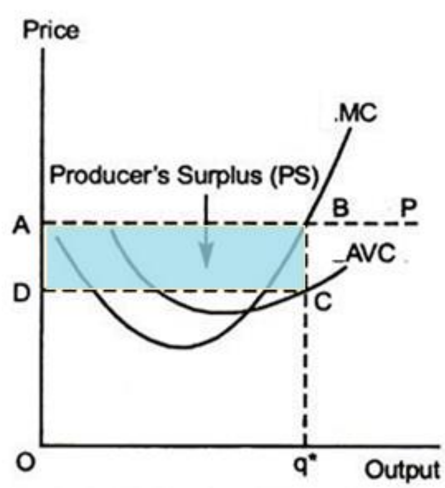


c) Short run market equilibrium in perfect competition



d) Producer surplus of an individual firm in perfect competition





2.

I. **What are the key items included in gross fixed capital formation (03 marks)**

a. Dwellings
b. Other buildings and structures (Land improvements)
c. Machinery and equipment
d. Cultivated biological resources (Animal resources yielding repeat products)
e. Costs of ownership transfer on non-produced assets
f. Intellectual property products (Research and development, Software)

(Any of the 3 correct answers 3 marks)

II. **State whether the following items are included or excluded in the measurement of current year's GDP in a country and explain your answer in each case.**

a) A housewife grows vegetables in her home garden during the current year and the entire harvest is used for home consumption.

Included: All goods produced by households are within the production boundary. (01 Mark)

b) A retired worker receives a pension payment from the government.

Excluded: Retired worker is not in the current labour force and the productive value of his past service cannot be included in current year's GDP. Further, the pension payment is a transfer payment which does not represent a factor income. Therefore, it is not included either in GDP or GNI. (01 Mark)

c) A motor vehicle dealer earns a commission for selling a second –hand car.

Included: The commission earned by a second-hand car dealer represents a payment for a productive service — trade. Value addition in trade i counted in GDP. (01 Mark)

d) A mother helps her daughter to learn a lesson in mathematics at home.

Excluded: The production of services by members of the household f their own final consumption is excluded from measured production national accounts.

III. **Explain the following terms;**

a) Value added (01 Mark)

- Value added is the output of the firm minus all inputs that it buys from other firms. (1/2 Marks)
- It is thus the amount added to the value of the product in question by the firm's own activities. The sum of the values added by all the firms in the economy is the nation's total output, its national product.(1/2 Marks)

b) Inventory investment (01 Mark)

- Inventory investments are additions to stocks of raw materials, semi-finished goods, and finished goods held by the firm. (1/2 Marks)
- The level of inventory investment by a firm will depend upon its forecasts about future demand and its resulting output plans. Inventory investment tends to be closely related to changes in production. Higher levels of output require more inventory investment in order to maintain the production process smoothly. (1/2 Marks)

c) GDP deflator (01 Mark)

- GDP deflator is a measure of the level of prices of all final goods and services produced in the economy. GDP deflator measures the ratio of nominal (or current prices) GDP to the real (constant prices) GDP. (1/2 Marks)

$$GDP\ deflator = \frac{Nominal\ GDP\ (GDP\ at\ current\ price)}{Real\ GDP\ (GDP\ at\ constant\ price)}\ x\ 100$$

(1/2 marks)

d) Non-produced non-financial assets (01 Mark)

- In national accounts, non-financial non-produced assets consist of assets that have not been produced within the production boundary, and that may be used in the production of goods and services. This is a component of Gross Domestic Capital Formation (1/2 Marks)
- Non-financial non-produced assets consists of natural resources (e.g. land, mineral and energy reserves, non-cultivated biological resources such as virgin forest, water resources, radio spectra and others), contracts, leases and licences as well as goodwill and marketing assets. (1/2 Marks)

e) **Commodity balance identity (01 Mark)**

- Commodity balance identity is the compulsory balance that takes place in goods and services account in national counting. This stresses the situation that in a particular period of time, total goods and services acquired by an economy equals to the total goods and services utilized by that economy. (1/2 Marks)

IV. Following are some hypothetical information's related to an economy. (All values in rupees' millions)

Compensation of employees	**6000**
Fixed capital consumption	**1000**
Taxes on product	**200**
Subsidies on product	**250**
Net foreign primary income	**-5000**
Net taxes on production & imports	**1600**
Mixed income	**4000**
Net operational surplus	**8000**
Net foreign current transfers	**2000**
Implicit price index (2010=100)	**400**

Calculate the followings

(a) **Gross domestic income at basic price**

Compensation of employees	6000
Net operational surplus	8000
Mixed income	4000
Fixed capital consumption	1000
Taxes less subsidies on product(200-250)	-50
Gross domestic income @ basic price	Rs.18950 **(2 marks)**

(b) **Gross domestic income at market price**

Gross domestic income @ basic price	18950
Net taxes on products & imports	1600
Gross domestic income @ market price	Rs.20 550 **(1 mark)**

(c) **Net national income at market price**

Gross domestic income	20 550

Net foreign primary income	-5 000
Gross national income	15 550 (W1)
Fixed capital consumption	-1 000
Net national income	Rs. 14 550 million **(1 mark)**

(d) **Gross national income at market price**

Gross national income = Rs.15 550million (W1) **(1 mark)**

(e) **Gross domestic income at constant price**

$$\text{GDP deflator} = \frac{\text{nominal GDP X 100}}{\text{Real GDP}}$$

$$\text{Real GDP} = \frac{\text{nominal GDP}}{\text{GDP deflator}} \times 100$$

$$= \frac{20\,550}{400} \times 100$$

= Rs.5137.5 Million **(2 marks)**

(f) **Disposable gross national income**

Gross national income	15 550
Net foreign current transfers	2 000
Disposable gross national income	Rs.17 550 million **(1 marks)**

3.

I. **Briefly explain the difference between "Investment multiplier" and "tax multiplier". (04 marks)**

- Investment multiplier can be defined as the number of times national income (real output) changes as a result of a change in investment

  Or

- The ratio that explains the impact happens on income (real output)as a result of a change in investment (either one of the definitions 1/2 mark)
- When Investment is changed national income get changed by the same amount initially. Part of this this additional income turns in to consumption expenditure and crates many circular of output expansion. This process continues up until additional investment injected in to the main circular flow has been fully leaked out. Investment multiplier

explains number of times national out pull will go up as against the change in investment when this total process is over. (01 mark)

- Tax multiplier can be defined as the number of times national income (real output) changes as a result of a change in autonomous tax/indirect tax/lump sum tax. (1/2 mark)
- Indirect taxes affects negatively on disposable income of households. As a result there is a negative co-relationship between Indirect taxes and national income. Tax multiplier explains number of times national income (real output) changes as a result of a change in autonomous tax/indirect tax/lump sum tax (1 mark)

II. In a particular hypothetical economy some of the macro-economic statistics are given below. Consider all values are in Rs. Billions.

Autonomous consumption	**= 2000**
Planned investment	**= 5400**
Government Purchases	**= 1600**
Net exports	**=1000**
Marginal propensity to consume	**= 0.8**
Taxes	**= 1000**

a. Construct expenditure function of this economy (02 marks)

Working I

$A_0 = a_0 - bT_0 + bTr_0 + I_0 + G_0 + NX_0$

$A_0 = 2000 - 0.8(1000) + 5400 + 1600 + 1000$

$A_0 = 9200$

Working II

$E = A_0 + (MPC)\ Y$

$E = 9200 + 0.8\ Y$ (02 Marks)

b. Calculate investment – savings gap at the equilibrium national income. (04 marks)

Working I

$Y = E$
$Y = 9200 + 0.8\ Y$
$Y - 0.8Y = 9200$
$0.2\ Y = 9200$
$Y = 9200/0.2$
$Y = 46{,}000$

Working II

$S = -2000 + 0.8\ Yd$
$S = -2000 + 0.8\ (Y - 1000)$
$S = -2000 + 0.8\ Y - 800$
$S = -2800 + 0.8Y$

If $Y = 46000$
$S = -2800 + 0.8\ (46{,}000)$
$S = -2800 + 36800$
$S = 34{,}000$

Working III

Investment – savings gap = I – S

= 5400 – 34,000

= - 28600 billions (04 Marks)

c. **Show first 3 rounds of multiplier effect if this economy receives Rs.2000 billion additional investment. (02 marks)**

1st round

Income will get increased by 2000 billions

2nd round

Income will get increased by 1600 billions

(2000 X 0.8)

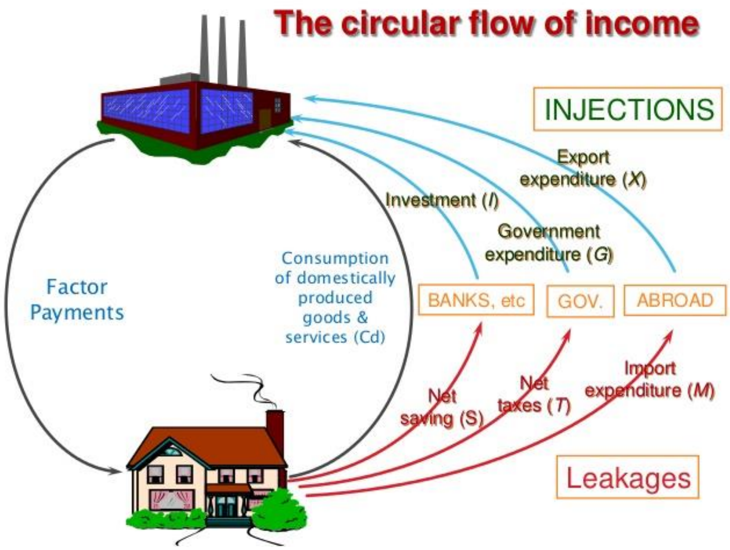
3rd round

Income will get increased by 1280 billions

(1600 X 0.8)

(any of the 3 correct answers 02 marks)

III. **Injections and withdrawals can make disequilibrium in macro- economic equilibrium and lead the economy to either contract or expand its economic activities. Using a circular flow of a simple economy that has only two sectors, explain this idea. (04 marks)**



(01 Mark For the correct diagram. Only savings and investments is required for the correct answer)

- If there are no injections or leakages in a simple economy Y=E (Output = Expenditure)
- If savings happen, households are spending less amount of their income on goods and services (not total income). Thereby, Y > E. (01 Mark)

  For example in a situation where Y= E = 1000, if households make savings of 200, then Y (= 1000) > E(=800)
- This lead in to contraction of the economy, since demand for goods is less than total output of the economy. (1/2 Marks)
- On the other hand, if injections happen, total demand of the economy would be greater than total output. Thereby, Y < E. (01 Mark)

  For example in a situation where Y= E = 1000, if injection of 200 takes place, then Y (= 1000) < E(=1200)
- This lead in to expansion of the economy, since demand for goods is more than total output of the economy.(1/2 Marks)

IV. Explain the effect of long run aggregate supply curve due to the following incidences.

a. Increase in price level – No impact(1/2 Marks)

   Changes in price level will not have any effect on the LRAS curve and on the equilibrium level of income in the long run as well. (1/2 Marks)

b. Increase in labour force – Rightward shift(1/2 Marks)

Increase the labour force will increase the full employment level of the economy. Thereby LRAS curve will shift rightwards. (1/2 Marks)

c. Increase in capital stock - Rightward shift(1/2 Marks)

   Increase capital stock force will increase the full employment level of the economy. Thereby LRAS curve will shift rightwards. (1/2 Marks)

d. Improvement in technology - Rightward shift(1/2 Marks)

   Improvement in technology will increase the full employment level of the economy. Thereby LRAS curve will shift rightwards. (1/2 Marks)

6.

I. Explain the effect of the change in money market on aggregate demand. (03 marks)

- Based on the availability of funds in the money market certain component of aggregate demand will get changed.
- Through expansionary monetary policy availability of funds in the money market can be expended. When quantity of funds available in the money market increases thus, interest rates falls and it will make personal consumption (C) and the investment (I) of the economy will get increased. As a result aggregate demand increases. (02 mark)
- Through contractionary monetary policy availability of funds in the money market can be reduced. When quantity of funds available in the money market reduces thus, interest rates rises and it will make personal consumption (C) and the investment (I) of the economy will get decreased. As a result aggregate demand decreases. (02 mark)

<u>Alternative answer</u>

- Money supply is one of the main causes that can change aggregate demand of the economy. (1/2 Marks)

- If money supply increases, general public get more currency balances and thereby they tend to demand more goods and services. As a result private consumption will go up and it will create an increase in aggregate demand. (1/2 Marks)

- Further with the increase in money supply, since money is readily available cost of funds (interest rates) falls and business will tend to invest more and through the increase in investment aggregate demand will go up. (1/2 Marks)

- With the increase in money supply government will have higher ability to make government expenditure and with less cost of funds government will be able to fund its budget deficit at a less cost. Thereby public consumption and investment will go up and it will also enhance the aggregate demand (1/2 marks)

- If money supply falls, the reserve of the above processes will take place and thereby aggregate demand falls with the decrease in money supply. (1 Mark)

II. Distinguish between 'headline inflation' and 'Core inflation' (03 marks)

<u>Headline inflation</u>

- Raw inflation figure as reported through the consumer price index (CPI) that is released monthly by the department of census and statistics of Sri Lanka. (1/2 marks)
- In other wards actual change of general price level during a particular time period. (1/2 marks)
- This measures inflation of overall economy. (1/2 marks)
- Headline inflation can often get fluctuated by the temporary or sudden price hikes those frequently take place in food and fuel due to seasonality and other external factors. (1/2 marks)

<u>Core inflation</u>

- This is a measure of inflation that excludes certain items that face volatile price movements those are included in headline inflation. (1/2 marks)

- In other words, headline inflation adjusted for seasonality or for the often volatile elements of food and fuel prices is known as the core CPI (1/2 marks)
- Core inflation represents the long run trend in the price level. (1/2 marks)
- Core inflation eliminates products that have temporary price shocks because these shocks can diverge from the overall trend of inflation and give a false measure of inflation. (1/2 marks)

III. Why do people hold money? What effect does the level of income have on the amount of money people hold? (03 marks)

- People hold money due to 3 main reasons;
  a. Transaction motive (1/2 marks)
  b. Precautionary motive (1/2 marks)
  c. Speculatory motive (1/2 marks)
- There is a positive (direct) relationship between income and money demand. (01 mark)
- Due to the change in income both transactional money demand and precautionary money demand get changed. (1/2 mark)

IV.A commercial bank that operates with in a banking system that follows a reserve requirement of 20% has total deposits of Rs. 8400 million, reserves of Rs. 2100 million and loans made wroth Rs. 6300 million. statutory

a) Calculate the excess reserves of the commercial bank. (01 mark)

Actual reserves	= 2100
(LESS) Statutory Reserves (Deposits X SRR) (8400X 20%)	= 1680
Excess reserves	= Rs.420 million(01 mark)

b) Construct the balance sheet of the commercial bank after it makes loans to the full - amount of its excess reserves. (02 marks)

Balance Sheet (Rs. million)

Deposits	8820	Reserves	2100
		Loans	6720
	8820		2940

c) Construct the balance sheet of the commercial bank after the clearing of the cheques that were written by the parties who borrowed. (02 marks)

Balance Sheet (Rs. million)

Deposits	8400	Reserves	1680
		Loans	6720
	8400		8400

V. Based on the monetary act what are the key instruments vested on CBSL to conduct the monetary policy? (03 marks)

- Open market operations
- Statutory reserve requirements on commercial bank deposits
- Bank rate
- Foreign exchange operations
- Quantitative limitation of loans
- Maximum interest rates
- Refinance facilities
- Moral suasion

VI. What are the key components of a financial system in Sri Lanka (03 marks)

1.Financial market

Money market
Foreign exchange market
Govt. securities market
Private securities market
Share Market

2.Financial Institutes

Banks
Financial companies
Leasing companies
Primary dealers
Money Brokers
Unit Trust
Insurance companies
Micro finance companies
Pension funds
Financial intermediaries

(01 mark for each component)

3.Financial instruments

Deposits
Equities
Loans
Treasury Bills
Commercial Papers
Debentures
Derivatives
Cooperate Bonds

4.Financial infrastructure

Cheque clearing system
Script less securities settlement system
Credit trading system
Real time gross settlement system

5.Regulatory institutions

Central Bank of Sri Lanka
Securities and Exchange Commission of Sri Lanka
Insurance Board of Sri Lanka
Colombo Stock Exchange
Pension Fund Department
Cooperative Department

7.

I. **What is meant by 'public bad'? Provide examples for 'public bad'? (03 marks)**

- Goods those create a common negative utility on persons or society/communities are known as public bad. (02 Mark)
- Examples for public bad are climate changes due to global warming, global terrorism, epidemics such as Ebola, Influenza H1N1 etc. (01 Mark)

II. Explain the difference between soft infrastructure capital and hard infrastructure capital. (2 marks)

- Proving infrastructure facilities is one of the ways in which the government contributes to the process of economic growth.
- There are 2 categories of infrastructure namely,
  1. Economic infrastructure
  2. Social infrastructure.
- These can be again divided into 2 sub categories namely soft infrastructure and hard infrastructure. Thereby the 4 categories of infrastructure can be summarized as follows.

Infrastructure Category	Hard Infrastructure Capital	Soft Infrastructure Capital
Economic Infrastructure Capital	Roads, expressways, bridges, subways, railways, airports, irrigation systems, harbors, telecommunication, energy, transport services(1/2 Marks)	Vocational training programs, Financial institutional facilities, research and development facilities, Exchange of technology, export incentives(1/2 Marks)
Social Infrastructure Capital	Hospitals, schools, water supply, houses, child/adult protection, prisons, disposal of garbage(1/2 Marks)	social security, community services, environment protection institutes(1/2 Marks)

III. What are the social costs of privatization? (03 Marks)

- Neglects social welfare since profit become the key incentive of the private sector
- Creating a private monopoly instead of public monopoly
- Weaken the employee motivation due to reduction in some perks of the employees
- Exploitation of public properties

(any of the 03 correct answers 03 marks)

IV. What is meant by "Government debt sustainability"? State the importance of primary account balance in determining debt sustainability. (04 mark)

- The ability of a country to fulfill its present and future debt servicing liability, without changing the debt repayment conditions and without making adjustments in fiscal policy is known as government debt sustainability.(01 mark)
- The primary surplus plays a critical role in decelerating the pace of debt accumulation as it helps to fund a part of refinancing obligations instead of shifting the entire burden of debt servicing obligations on future borrowings. (1/2 Mark)
- The primary balance of the budget is defined as the fiscal balance net of interest payments and is considered as a key determinant of the government debt dynamics. (1/2 Mark)
- A deficit in the primary balance is equal to the difference between revenue and non interest expenditure. It determines the extent of borrowings by the government for its expenditures other than the interest payments. (01 Mark)
- Moreover, if the government achieves a sufficient primary surplus to meet the interest payments given the other factors, then the debt to GDP ratio will be stabilized at the existing level, reflecting the fact that there would not be new borrowings beyond the roll-over requirement of capital payments. If the primary surplus further increases, then the debt to GDP ratio would be falling over time and vice versa. (01 Mark)

<u>For study purpose:</u>

- In addition to primary account balance, in an open economy, the behavior of major macroeconomic variables such as GDP growth, real interest rates and exchange rates provide valuable inputs for debt sustainability analysis.
- Govt. debt as a percentage of GDP, is one of the key indicators used to evaluate debt sustainability.

V. Explain the following concepts, and show how to derive those using equations. (04 marks)

a. Social cost

- The total cost of a particular production or consumption activity borne by the whole society is called social cost. By adjusting external cost to private cost the social cost is determined.

Social Cost = Private cost + External cost(1 Mark)

- Private costs are the costs borne by a particular person when they directly involve in a production or a consumption activity. (1/2 Mark)

- External costs are the costs borne by external parties of a particular production or consumption activity and these costs are borne by external parties who do not directly involve in the production activity. (1/2 Mark)

b. Social benefit

- The total benefit resulting from a particular production or consumption activity borne by the whole society is called social benefit. By adjusting external benefit to private cost the social benefit is determined.

Social Cost = Private cost + External cost (1/2 Mark)

- Private benefits are the benefits received by a particular person when they directly involve in a production or a consumption activity. (1 Mark)
- External benefits are the benefits received by external parties of a particular production or consumption activity and these benefits are received by external parties who do not directly involve in the production activity. (1 Mark)

VI. Explain the following concepts regarding public finance. (04 marks)

1. Recognition lag

- Recognition lag is a situation where policy makers are unable to identify economic problems existing in an economy at an early stage. It may take a considerable amount of time to recognize the problems in the economy. (1 Mark)

  Eg: The economy may be in recession for months and policy makers only recognized it after a considerable amount of time. (1 Mark)

2. Administrative lag

- Recognition lag is a situation where it takes a considerable amount of time to implement necessary policy actions after recognizing the problems existing in the economy. (1 Mark)
- It may take a considerable amount of time to change the existing tax policies, expenditure policies and to implement necessary policies after recognition of an economic problem. (1 Mark)

6.

I. **“Balance of payment should always get balanced”. Do you agree with this statement? (3 marks)**
   - Yes, I agree (01 mark)
   - When recording transactions in the BOP, the double entry principle is used. Thereby when transactions are recorded in credit columns and debit columns in equal amounts, the net balance of all transactions will be zero. (02 mark)

II. **What are special drawing Rights? How is their value determined? (03 marks)**
   - The SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries’ official reserves. (01 mark)
   - SDRs can be exchanged for freely usable currencies.
   - The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. (1/2 marks)
   - Holders of SDRs can obtain these currencies in exchange for their SDRs in two ways:
     a. first, through the arrangement of voluntary exchanges between members;
     b. and second, by the IMF designating members with strong external positions to purchase SDRs from members with weak external positions.

   How SDR value is determined

   - SDR was redefined as a basket of currencies. Effective October 1, 2016 the SDR basket consists of the US dollar, euro, the Chinese renminbi, Japanese yen, and British pound sterling. (01 mark)
   - It is calculated as the sum of specific amounts of each basket currency valued in US dollars, based on exchange rates quoted at noon each day in the London market. (1/2 marks)

III. **What are the key reasons for the international specialization (03 Marks)**
   a. Changes of resource endowment (01 Mark)
   b. Changes of the preferences (01 mark)
   c. Economies of scale of production (01 mark)

IV. **If a country has been having a deficit in the Balance of Payments over a long period, which recommendations that can be made to control it? (04 marks)**
   (Any 4 correct answers 4marks)

- Promoting existing exports and promote export diversification
- Establishing export promoting zones
- Getting in to trade agreement with major markets
- Promote import substitute industries
- Devalue currency if export and import elasticities are favorable for devaluation
- Control domestic inflation to make local exports to be competitive.
- Discourage non-essential imports

V. How do you estimate the 'external resource gap '? (04 marks)

- External resource gap is the gap between foreign receipts and foreign payments (1 Mark)
- Foreign receipts is the summation of followings: (1 ½ mark)
    a. Goods exports
    b. Service receipts
    c. Primary income receipts
    d. Private secondary income receipts
- Foreign payments is the summation of followings: (1 ½ mark)
    a. Goods imports
    b. Service payments
    c. Primary income payment
    d. Private secondary income payment
    e. Private capital transfer payment
    f. Loan repayment (capital repayment)
    g. Capital outflows (FDI and Portfolio investment outflow)
    h. Commercial bank net liabilities

VI. Distinguish between external balance and internal balance (3 marks)

- Internal balance is creating a proper balance between two important the macro -economic objectives namely full employment and price level of the economy. (1/2 marks)
- Full employment and price level are two conflicting macro-economic objectives. For example if employment rises price level also raises (inflation) and vise-versa. (1/2 marks)
- Hence one has to compromise to improve the other. Thus, economy should make a balance between those two macro-economic objectives. (1/2 marks)

- External balance is balancing the BOP. In fact it is balancing the BOP current account. (1/2 marks)
- There can have an impact to external balance when an economy is striving to achieve internal balance. (1/2 marks)
- Therefore, most of the economies give more priority to internal balance rather than external balance. (1/2 marks)

07.

I. **What are the key benefits of economic growth? (03 Marks)**

(any of the 3 correct answers 03 marks)

- Increase in quality of life (Higher production & higher consumption)
- Increase in employment (Better & more employment opportunities)
- Strengthening government revenue (Higher tax collection)
- Increase in savings & investment (Increase in income & aggregate demand)
- Higher business confidence (Increase in return on entrepreneurship & investment)
- If the growth is pro-poor growth it leads to eradicate poverty

II. **"High levels of savings are a necessary but not a sufficient precondition for economic growth" Do you agree? Give reasons. (5 marks)**

- Yes, I agree (01 mark)
- Savings is an essential element for an economic growth since savings is the source of capital formation (investment). However having a high level of capital formation alone is not suffice for the economic growth (01 Mark)
- With the increasing amount of capital formation (investment) following factors should also be combined for an economic growth: (any of the 03 following factors 03 marks)
    a. Efficiency in capital formation (whether capital formation is directed at an area that can contribute to economic growth)
    b. Technology
    c. Education and training

d. Entrepreneurship

e. Research and development

f. Proper coordination between different investment projects (direction of the government)

g. Macroeconomic stability

h. Institutional framework that is favorable for economic growth

III. Outline the importance of foreign direct investments to Sri Lanka. (4 marks) (Any correct 4 points – 4 marks)

- In order to accelerate economic growth and reduce pressure on long term BOP deficit
- In order to improve exports of Sri Lanka by introducing new technology
- Improve capabilities
- Introduce new management practices
- In order to connect Sri Lankan in to global production networks

IV. What are the steps taken by the government during the period 1970-1977 to reduce disparities in income distribution?(04 marks)

- Introducing limits on maximum amount of land that an individual can own through the Land Reforms Act. Of 1972.
- Decision to of currency notes with the denominations of Rs.50 and Rs.100 (highest value notes at that time) through the budget presented in 1970.
- Increasing taxes imposed on salaries
- Increasing taxes imposed on international trade
- Empowering low income earners by granting subsidies for agricultural activities
- Introducing regional development projects in rural areas
- Restricting import of luxury goods
- Promoting import substitution industrialization
- Expanding employment opportunities in public sector

V. **'Even though business cycles show the variance of output in an economy, business cycle is not an appropriate measurement to measure, economic growth of an economy'. Do you agree with this statement? Explain your answer. (04 marks)**

- Agree with the statement (01 Mark)
- Economic growth can be defined as the long term sustainable expansion of the ability of goods and services production or continuous increase of potential GDP or potential national income for a long period of time. Thereby, economic growth is a long term process. (02 Marks)
- However, business cycles only show the short term fluctuations of the output of an economy (01 Mark)
- Thus, business cycle is not an appropriate measurement to measure economic growth of an economy.