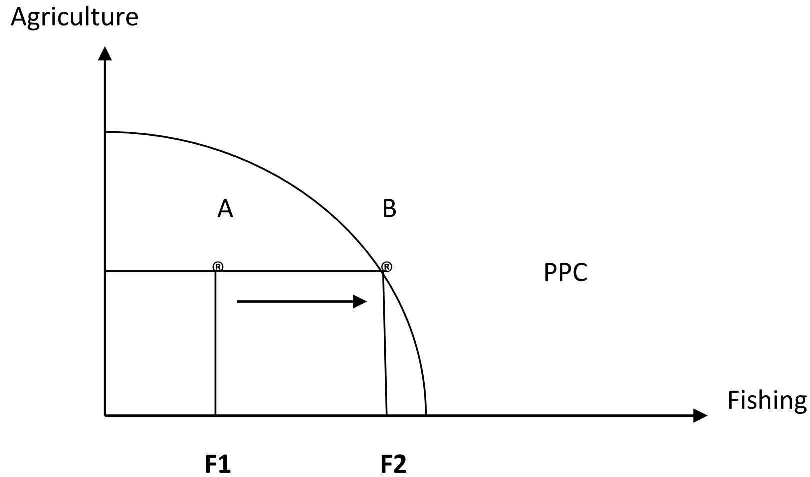
Week 12 – Mock Paper

1.

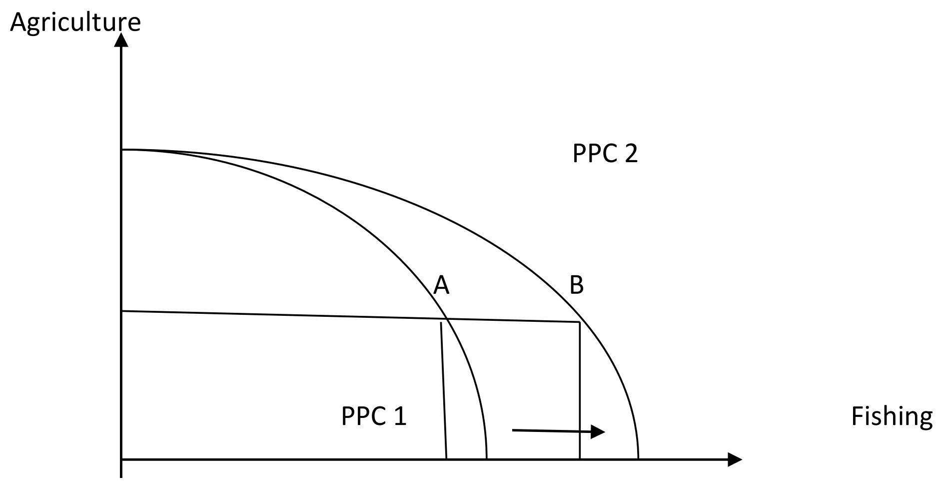
i. Represent the following situations which are related to the Sri Lankan economy using a PPC with increasing opportunity cost.

a) **Re opening of warmer high security Zone fishing areas for fishermen. (02 Marks)**



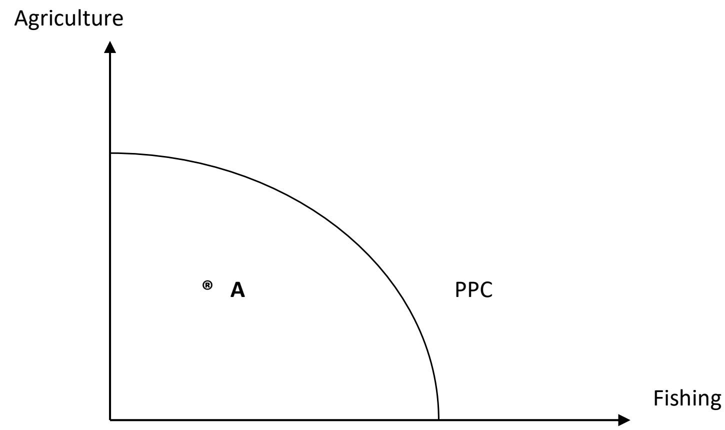
- Re opening of high security zone fishing areas enable fishermen to use previously available, unutilized areas for fishing. It will decrease unemployment of resources, thereby a point inside the PPC will move towards the PPC.

b) **Donation of trollar machines by the Indian government to uplift the fishing industry in Sri Lanka. (02 Marks)**



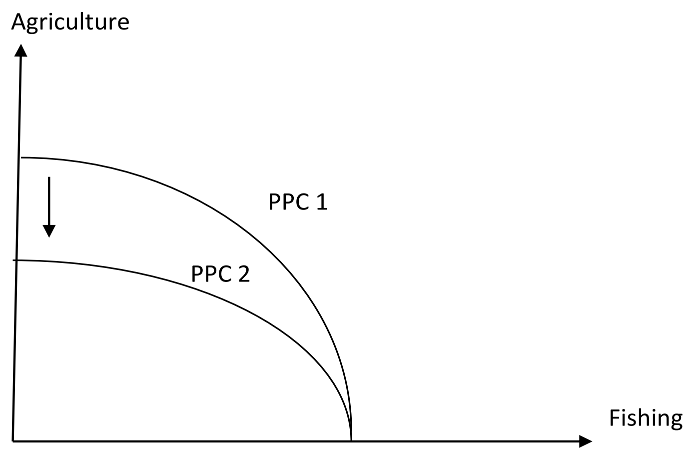
- Donation of trollar machines will increase the amount of resources available for fishing industry. Thereby production possibilities in the fishing industry will increase, causing the PPC to shift to right from one side. (fishing industry side)

c) **Unemployment in the economy (02 Marks)**



- With unemployment, an economy will not be able to reach its full employment level of output. Thereby the economy will be operating at a point inside the PPC.

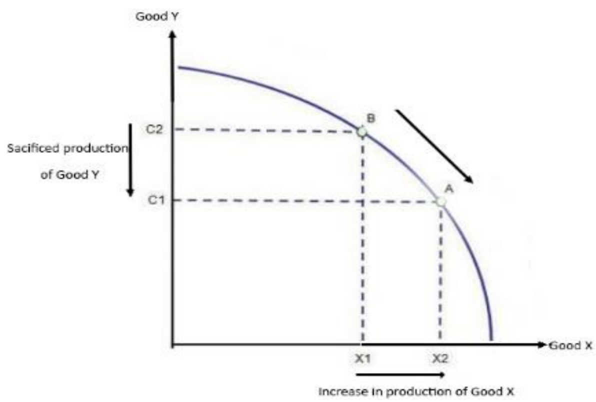
d) **Reduction in space available to harvest after a natural disaster. (2 marks)**

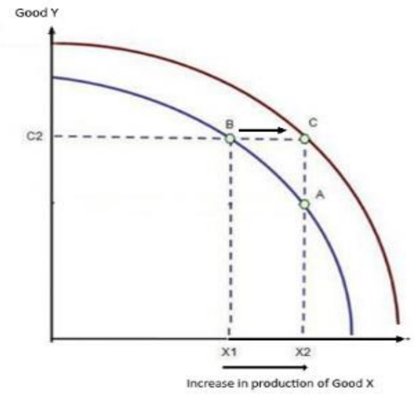


- A natural disaster will affect the resource supply of the economy, causing a decrease in production possibility. As the question says it affects space available to harvest, it will only affect the agriculture sector.

ii. "A static economy (operating on the PPC) without any growth will be able to increase production of a particular product only by scarifying production of another product. But a growing economy will be able to increase production without any sacrifice. "Do you agree? Explain using relevant diagrams. (4 marks)

- Yes, I agree(1mark)





(1mark - graphs)

- If a static economy without any growth (already operating on a point on the PPC) needs to increase production of Good X, it needs to change the product combination B to product combination A. (1/2 mark)
- In order to increase production of product X, economy will have to sacrifice production of product Y. It will cause an opportunity cost. (1/2 mark)
- If a growing economy needs to increase production of Good X, it needs to change the product combination B to product combination C. (1/2 mark)
- It can do so without any change in the quantity of Good Y produced. It is because the production capacity of economy has increased as a result of economic growth. In this situation the economy can increase production without an opportunity cost. (1/2 mark)

iii. **What can you say about a PPC which is convex to the origin? Comment on the nature of resources used in this scenario. (04 marks)**

- Convex to the origin PPC depicts the decreasing opportunity cost. (Slope of the PPC is decreasing). (01 Mark)
- Decreasing opportunity cost is the model that shows opportunity cost (the value of forgone production) decreases as the quantity of goods produced increase. (01 Mark)
- Reasons for decreasing opportunity cost :
  Due to increasing returns to scale (01 Mark)
  - ✓ Increasing returns to scale means the drop in resource cost of production due to the rise of efficiency in production with the increase of scale (large volume production)
  - ✓ Due to returns to scale output rises more than proportionate times to the rise in input.

- ✓ As a result, the amount that has to be sacrificed from the other good to produce one unit of a particular good gradually drops (Explanation 01 Mark)

iv. 'Free goods can not be depicted in a production possibility diagram' do you agree with this statement? Comment. (04 Marks)

- Agree with the statement (01 mark)
- Production possibility curve represents the goods those are produced using scare resources (limited resources) (01 mark)
- That is the reason why opportunity cost can be shown from production possibility curve (01 mark)
- However, free goods are produced using non-scare resources and thereby carry no opportunity cost. Thus, free goods production can not be depicted through a production possibility curve. (01 mark)

2.

i. What are the main determinants of supply? And what factors are held constant when moving along the supply curve? (4 marks)

- Main determinants of supply are, (Any 4 points 3 marks)
  1. Price of the concerned good.
  2. Price of inputs used to produce the concerned good.
  3. Technology
  4. Price of related goods
  5. Producer expectations
  6. Number of producers in the market
  7. Government policies
  8. Other factors
- All of the determinants of supply, except price of the concerned good are held constant when moving along the supply curve. (01 mark)

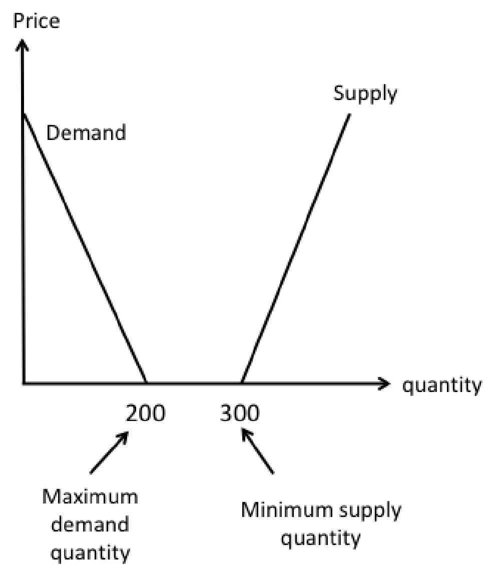
ii. In a particular market demand and supply equations have been given as follows:

$$Qd = 200 - 10p$$

$$Qs = 300 + 10p$$

Can this market arrive at market equilibrium? Explain. (04 marks)

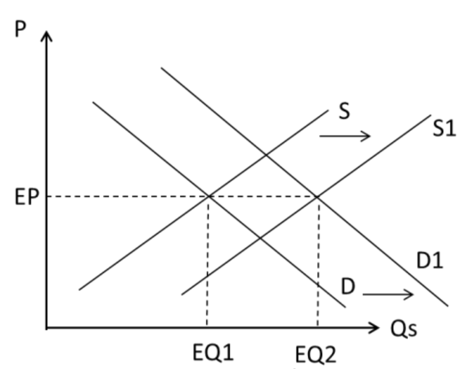
- This market is unable to arrive to market equilibrium due to the fact that minimum supply quantity (300) is higher than maximum demand quantity (200). (1 mark)
- Thereby there can have no positive intersection point between these two demand and supply curves. (1 Marks)
- As it shown in the diagram below starting point of the upward sloping supply curve on the quantity axis stay away from the ending point of the downward sloping demand curve at the quantity axis. Thus, there can have no intersection point between these two curves. (01 Mark)



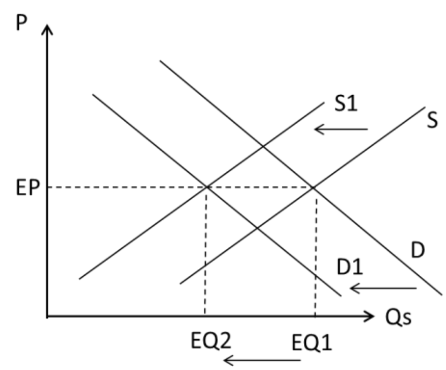
(Diagram 01 mark)

iii. Using appropriate diagrams explain following situations.

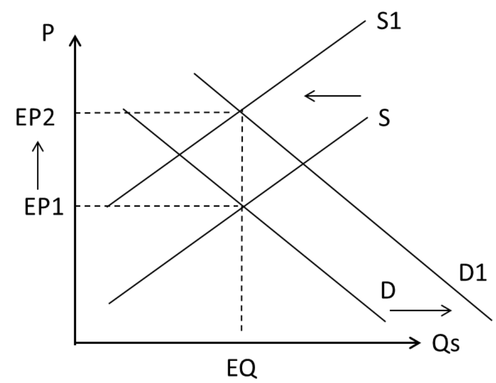
a. As a result of a change in both demand and supply curves equilibrium quantity has increased but equilibrium price remains unchanged. (01 Mark)



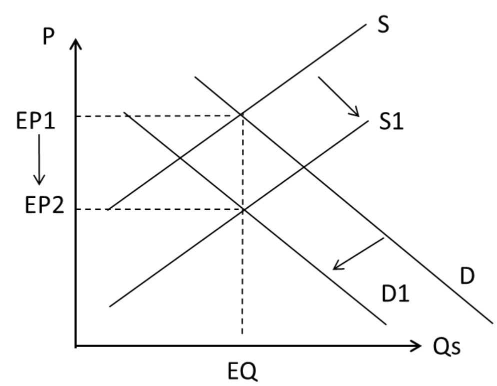
b. As a result of a change in both demand and supply curves equilibrium quantity has decreased but equilibrium price remains unchanged. (01 Mark)



c. **As a result of a change in both demand and supply curves equilibrium price has increased but equilibrium quantity remains unchanged. (01 Mark)**



d. **As a result of a change in both demand and supply curves equilibrium price has decreased but equilibrium quantity remains unchanged. (01 Mark)**



iv. **Explain the law of supply and mention why the supply curve slopes upwards. (02 marks)**

The law of supply indicates that there is a positive relationship between the price and the quantity supplied when of the concerned good when other factors held constant at a specific situation. (01 marks)

The supply curve slops upwards due to two reasons,

- **Profit (Marginal profit) –** When price of the concerned good increases new suppliers enter the market due to the increase in marginal profits. Further when the price drops a group of suppliers exit from the market due to the reduction of marginal profits. (1/2 mark)

- **Increasing opportunity cost –** Marginal opportunity cost (Marginal cost) rises when output is increased under increasing opportunity cost due to heterogeneity of resources (resources are not perfect substitutes for both industries. Thereby at higher quantities a higher price needs to be charged.it creates a positive relationship between price and quantity supplied. (1/2 mark)

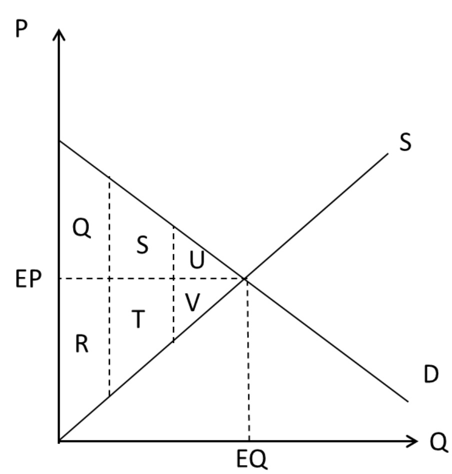
v. 'When a market arrives to its allocative efficiency, it satisfies 3 conditions'. What are those conditions? (02 Marks)

- Marginal benefit equals to marginal cost (MB=MC)
- Maximum price consumers are willing to pay for a particular product equals to minimum price expected by a producer.
- Economic surplus reaches its highest value.

(If all answers are correct 2 marks, for two correct answers 01 mark, only one correct answer no marks)

vi. In a competitive market when there is an equilibrium exchange, economic surplus of that market reaches its maximum. Explain this statement. (04 marks)

- Highest economic surplus, which is the summation of consumer surplus and producer surplus, takes place exactly when the market reaches its equilibrium point. (when the market reaches allocative efficiency) (01 Mark)
- As it is shown in the graph, when quantity rises economic surplus rises, from (Q+R) to (Q+S+R+T) to (Q+S+U+R+T+V). (01 Mark)
- Hence, when the market reaches its market equilibrium economy reaches its highest economic surplus.



(02 Mark For the graph)

3.

i. 'In oligopoly market, in order to restrict entry both natural and artificial barriers are used'. Briefly explain main entry barriers used in oligopoly market (04 Marks)

a. Economies of scale (1/2 Marks)

When the existing firms of the industry have reached to its 'minimum efficient scale', existing firms will be able produce large volumes at lowest cost possible. Thereby, it will be really difficult for a new firm to enter in the industry and compete with existing firms. (1/2 Marks)

b. Good will (image of the company/brand) (1/2 Marks)

When existing firms have very high credibility and consumer trust on them it is really difficult for a new entrant to compete with the existing firms. (1/2 Marks)

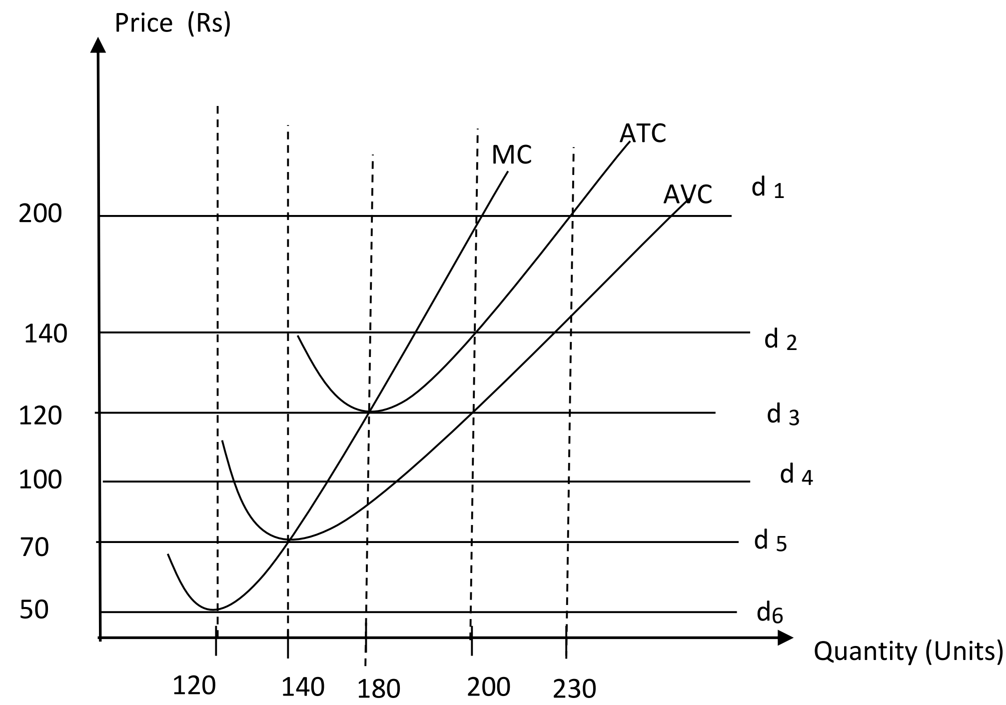
c. Strategic actions (1/2 Marks)

These are some of the policies and actions implemented by existing firms in order to avoid the entry of potential new entrants. For example, always exiting firms are operating with excess capacities, by which they would be able to increase their production at any given moment if a new entrant inters in to a market.

d. Legal barriers (1/2 Marks)

Using the patents and other intellectual property protections existing firms will be able to avoid the entry of other firms in the market. Further, through the legal contracts with distribution networks such as supermarkets, that existing firms can restricts potential entrants. Ex;- Block shelf space for new entrants through contacts with supermarkets. (1/2 marks)

ii. Information about a certain firm which operates in a perfectly competitive market within the short-run period is given from the diagram below.



a) **At which output level will this firm's short-run average product and marginal product be the same? Explain the reason for your answer. (1 mark)**
   - When the firm is producing 140 units (½ Marks)
   - It is because at the same quantity where AP= MP takes place, MC = AVC. (1/2 marks)

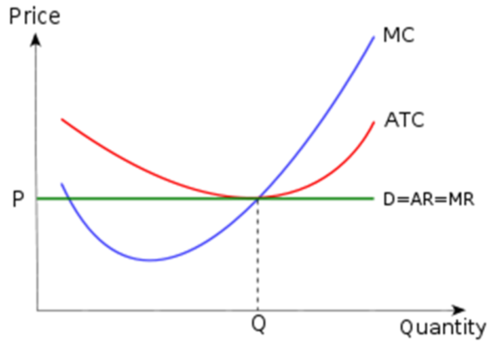
b) **At which price level will this firm make "Normal Profits?" Explain the reason for your answer. (1 mark)**
   - 180 units (1/2 marks)
   - When making normal profits is earned by a firm MC = lowest ATC = MR (1/2 Marks)

c) **At which output level is this firm's marginal product being maximized? Explain the reason for your answer. 1 mark)**
   - 120 units (1/2 Marks)
   - MC is a mirror reflection of MP. Thereby when MC is lowest, MP is at its maximum. (1/2 Marks)

iii. Perfect competitive firm achieves 'economic efficiency' in the long run. Do you agree? Explain your answer. (04 marks)

- Agree. (1/2 marks)
- Economic efficiency is the summation of both productive efficiency and allocative efficiency. (1/2 Mark)
- Therefore if a firm to achieve economic efficiency, such firm should produce a particular product at the lowest per unit cost possible (production efficiency) and the exact quantity that is desired by the society (allocative efficiency) (1/2 Mark)

- Thus, if a firm to achieve economic efficiency its optimum quantity and the profit maximization quantity should be the same. (1/2 marks)
- As result at that quantity, MC=MR= Lowest ATC (1/2 marks)
- This will only be achieved by a perfect competitive firm in its long run. (1/2 marks)



Graph (01 Mark)

iv. Why do we make the following conclusions about a firm in perfect competition?

A. the firm is a price taker (2 marks)

- In a perfect competition there are large number of buyers and sellers who are selling a homogenous product without having any entry or exit barriers. (3 marks)
- Since their quantity supplied is a negligible amount compared to market quantity, they have to supply at the market price regardless of the quantity that they have to sell. Therefore, they have to act as a **price taker** (2 marks)

B. The average revenue and the marginal revenue of the firm are equal (2 marks)

- Average revenue and the price are the same thing
  AR= TR/Q

  AR=P×Q/Q
  AR=P (2 mark)

- Marginal revenue (MR)is the additional revenue earned by selling an additional unit (1/2 marks)
- in a perfectly competitive industry all individual firms act as a price taker, faces a perfectly elastic demand curve. Each extra unit sold adds its price to total revenue. Therefore, **MR=P**
  AR=P=MR
- Therefore, AR=MR (3 marks)

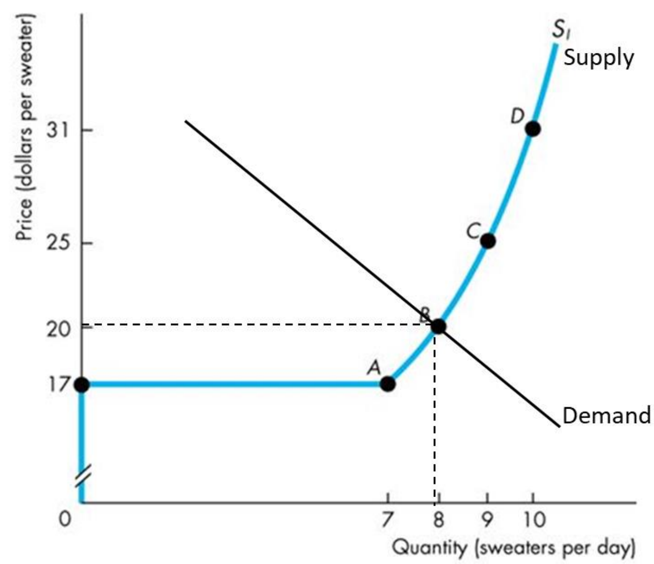
C. The firm can earn only normal profits in the long run (2 marks)

- If an industry earns economic profits it shows firms in that industry are earning more profits over and above other industries those can be operated with the same amount of investment (2 marks)

- With absence of barriers to entry in perfect competition attracts new firms to a market that earns normal profits in the long run and will have higher competition (1 mark)
- Therefore, In the long run economic profit will get distributed among many firms and all firms in the industry earns only normal profits. (1 mark)

v. **Using an appropriate diagram explain how perfectly competitive market arrive at the market equilibrium in the short run? (03 Marks)**

- Demand curve of the perfectly competitive market is constructed by aggregating all the quantities those are willing to be purchased by all consumers in the market at different market quantities. Thereby, demand curve is a downwards sloping curve. (01 Market)
- Market supply curve (industry supply curve) shows alternative quantities those are willing to be supplied when number of firms in a market remain constant and when capacity of each firm remain constant. Therefore, market supply curve becomes horizontal up to a particular level of output and thereafter it becomes an upward sloping curve. (01 Mark)
- Market equilibrium is decided by the interaction between demand and forces of the market in the short run.



(correct diagram 01 mark)

4.

i. **Even though some of the production activities are related to the production of new goods they are still excluded from national accounts. Do you agree with this statement? Explain your answer with examples. (03 marks)**

- Agree with the statement (1/2 Mark)

- Due to several reasons such as conceptual reasons, non-availability of statistics, not going through the market etc. some of the productive economic activities are excluded from the national accounts. (1/2 mark)
- There are mainly four categories of productive activities excluded from the national accounting:
  a. Some of the self-service activities (1/2 Mark)
  b. Non-observed economic activities (1/2 Mark)
  c. Production of natural resources purely by a natural process without any human involvement or direction (1/2 Mark)
  d. Leisure (1/2 Mark)

ii. Explain why an economy's total output in essence is also its total income (03 Marks)

- Crating production and generating income are two sides of the same coin. (1/2 marks)
- Income is generated when factors of production are provided to production process (1/2 mark)
- Thus, income generated is equals to the value of factors of production provided to production process. (1/2 mark)
- Furthermore, value of the output is equal to the value of factors of production included in output. (1/2 mark)
- Hence, income generated on a particular amount of factors of production will equal to the output produced by that factors of production. (1 mark)
- Therefore, in a particular year total output value at factor cost price equals to income generated within that year on factors of production contributed to the output. (1 mark)

iii. Why are interest payments by the government considered part of personal income but not part of national income? (04 Marks)

- Interest payment is a <u>transfer payment</u> which is a <u>unilateral payment.</u> (01 mark)
  - In national accounting calculations only <u>bi-lateral</u> payments are considered and therefore, **<u>interest payments are excluded</u>** from national accounting calculations. (01 mark)
  - Further interest payments are made on the loans (borrowings) obtained in previous years but not as a part of production process expenditure of the relevant year. That is another reason why **<u>interest payments are excluded</u>** from national accounting calculations. (1/2 mark)

- However, when personal income is calculated **<u>all income (bilateral and unilateral)</u>** income received by persons (Households) is considered. (1/2 mark)
- Therefore, interest income received by households is considered in personal income **<u>since it is a factor income (return on capital) of households.</u>** (01 mark)

iv. What are the reasons for fluctuations in GDP in the short run? Explain (2 marks)

- Changes in aggregate demand is the main reason for fluctuations in the GDP in the short run.(01 mark)
- It is because the full employment doesn't change in the short run. Therefore, the capacity which is being utilized from the full employment level of output will depend on aggregate demand. (01 mark)

v. The following macroeconomic data are given for an economy. (All figures are in Rs. Million)

National Income	**=**	**5 000**
Consumption	**=**	**2500**
Government Expenditure	**=**	**1250**
Net exports	**=**	**500**
Budget deficit	**=**	**200**

(a). Calculate disposable national income.(02 marks)

Disposable National Income:

Y_d = Y – NT (net taxes)

BD = G > T = 200

T = G – 200; 1250 – 200 = 1050

Y_d = Y – 1050

Y_d = 5000 – 1050 = <u>Rs.3950 million (02 Marks)</u>

(b). What is the value of investment of this economy?(02 marks)

* Value of Investment

Y = C + I + G + NX

Y – I = C + G + NX

I = Y – (C + G + NX)

I = 5000 – (2500 + 1250 + 500)

<u>I = Rs.750 Million (02 Marks)</u>

* Alternative answer

I + G + X = S + T + M

I = S + (T – G) + (M – X)

S = Y_d – C = 3950 – 2500 = 1450

T – G = 1050 – 1250 = 200

(X – M) = 500

M – X = -500

I = S + (T + G) + (M – X)

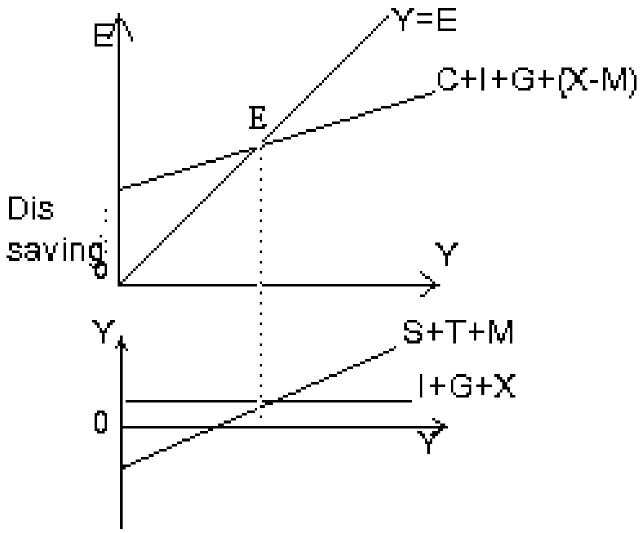
I = 1450 - 200 + (-500)

I = Rs.750 Million (02 Marks)

vi. Graphically show the two conditions that should be fulfilled in macroeconomic equilibrium of an open economy. (4 marks)

- Economy arrives to its equilibrium when Y=E or W=J.
- In other words, economy arrives to its equilibrium when there is no tendency to output to either expand or contract.(01 mark)
- Y= E criteria
    - Y = C+I+G+NX (1/2 mark)
- W=J criteria

S+T+M = I+G+X (1/2 mark)01)



(01 mark each for the correct graph)

5.

i. What do you mean by policy interest rates of the Central Bank of Sri Lanka? (02 marks)

- The policy interest rate is an interest rate that the monetary authority (i.e. the central bank) sets in order to influence the evolution of the main monetary variables in the economy (e.g. consumer prices, exchange rate or credit expansion, among others). (1/2 Mark)
- The policy interest rate determines the levels of the rest of the interest rates in the economy, since it is the price at which private agents-mostly private banks-obtain money from the central bank. (1/2 Marks)
- These banks will then offer financial products to their clients at an interest rate that is normally based on the policy rate.
- In Sri Lanka there are main 3 policy interest rates are used:
    a. Bank Interest rate

b. Standing lending facility rate (SLFR)

c. Standing deposit facility rate (SDFR)

(if all 3 policy interest rates are mentioned correctly 01 mark.)

Special note:

Current Policy Rates (Per cent per annum)	
Standing Deposit Facility Rate (SDFR)	6.5
Standing Lending Facility Rate (SLFR)	7.5
Bank Rate	15
Statutory Reserve Ratio (SRR)	5

ii. What is headline inflation? What are the factors that affect headline inflation?(4 marks)

- Headline inflation is the actual change of general price level during a particular time period. A temporary change in the price level as a result of supply shocks and administrative decisions is depicted through the headline inflation rate.(1 mark)
- Factors that affect headline inflation are,
    i. Increase in control prices.(Ex: Electricity, Transport)
    ii. Increase in prices of imports.(Ex:Oil, Wheat flour)
    iii. Changes in supply due to bad weather(Ex:Floods)
    iv. Increase in demand due to seasonal factors(Ex:New year, Christmas)
    v. Excessive expansion in money supply
    vi. High tax policies
    vii. Inflation expectations of consumers

    Any 4 points: 3 marks

iii. What factors could cause the actual expansion of the money supply to differ from that given by the deposit expansion multiplier? (3 marks)

- Liquidity preference of general public

  Theoretical maximum is calculated based on the assumption that money will not flow out from the commercial banking system until credit creation process is over. However in reality general public withdraw demand deposits (loans) and hold cash balances in hand. Thus, commercial banking system practically will fail to reach theoretical maximum.

- Banking system keeps excess reserves
  In reality commercial banking system can not only hold statutory reserve requirement to maintain trustworthiness. In other wards commercial banks has to maintain excess reserves. Therefore banking system is not reaching its theoretical maximum.
- Reduction in demand in credit
  Theoretical maximum assumes that there is enough demand for credit to supply total credit that could be created by the commercial banking system. However in reality there can have fluctuations in credit demand.
- Money leaking out from the banking sector to non-banking financial sector

(any of the 3 correct answers 03 marks)

iv. **Distinguish between quantitative and qualitative credit control methods of the Central Bank of Sri Lanka. (3 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. (1/2 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. (1/2 marks)

v. "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)

vi. The following is a simplified balance sheet for one of the banks in a commercial banking system in a country.

Liabilities	Value (Rs. Million)	Assets	Value (Rs. Million)
Deposits	120 000	Required reserves	18 000
Shareholders' equity	20 000	Excess reserves	5 000
		Securities	32 000
		Loans	85 000
Total Liabilities	**140 000**	**Total assets**	**140 000**

a) What is the required reserve ratio ? (1 mark)

$$Required\ reserve\ ratio = \frac{Required\ reserves}{Deposits} = \frac{18,000}{120,000} = 15\ \%$$ (1 mark)

b) Assume that a customer withdraws Rs. 5 000 million from his current account at this bank. By how much will this bank's reserve change based on this cash withdrawal? (2 marks)

Rs. 5000

c) **Assuming that the required reserve ratio remains unchanged, what is the maximum amount of new loans that this bank could make after the withdrawal of Rs. 5 000 million deposits? (2 marks)**

Amount of excess reserves after the cash withdrawal:

Actual reserves	=	18,000 + 5000 - 5000	= 18,000
Required reserves	=	115,000 x 15%	= 17,250
Excess reserves	=	18,000 -17250	= 750

Maximum amount of new loans = Rs. 750 (02 marks)

6.

i. **Name 4 policies that can be used to control inflation. (2 marks)**

- Control the growth in aggregate demand (1/2 Marks)
- Speed up growth in aggregate supply (1/2 Marks)
- Direct govt. intervention to control inflation (1/2 Marks)
- Remove barriers affecting efficient distribution of resources. (1/2 Marks)

ii. **What is producer price index and what are the key importance of producer price index (03 marks)**

- The PPI measures the average change over time in the prices received by domestic producers of goods and services. (01 Marks)
- Importance of the producer price index are,

  a. Indicator of inflationary trends (since changes of the producer price translates in to consumer prices with time)
  b. Helps foreign trade since producer price changes between different countries can be analyzed.
  c. Deflator of economic series
  d. Productivity analysis
  e. Current cost accounting
  f. Business analysis (since investors can predict the future inflationary trends)
  g. Policy-making

  (any of the 2 correct points 2 marks)

iii. **Increase in the use of electronic money will challenge the efficiency of the monetary policy? Do you agree? Explain. (3 marks)**

- Yes, I agree(1 Mark)
- Evolution of electronic money will lead to a decrease in use of traditional money. (½ Marks)
- As the monetary policy has been focused on controlling the traditional stock of money, electronic money will challenge the effectiveness of monetary policy. (½ Marks)
- When the use of traditional money decreases, the need of issuing currency and coins by the CBSL will also be reduced. This will be a threat to the main source of earning revenue of CBSL(½ Marks)

- Moreover, as e- money can be used efficiently and conveniently in carrying out transactions related to international trade, central bank's function of controlling foreign exchange will also get challenged. (½ Marks)

iv. "Nominal interest rates are always positive" Do you think that real interest rates are also positive? (03 marks)

- Real interest rate is inflation adjusted nominal interest rate.(1/2 mark)
- Real Interest rate = Nominal Interest rate – Inflation rate (1/2 mark)
- Thus, if inflation rate is equal to nominal interest rate, real interest rate becomes zero whereas if inflation rate is higher than nominal interest rate real interest rate becomes negative. (1 mark)
- Hence, real interest rate does not become positive always.

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

1. 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)

2. 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)

3. 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)

4. 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. A hypothetical balance sheet of a commercial banking system is given below:

Liabilities (Rs. Million)		Assets (Rs. Million)	
Demand Deposits	**2,000**	**Reserves**	**400**
		Loans	**1600**
Total	**2,000**	**Total**	**2,000**

Further , the currency held by public in this economy is Rs. 1,200 million and there is an excess reserve of Rs. 200 million in the banking system.

a) Calculate the maximum possible amount of total money supply in this economy when the full credit creation is completed. (03 marks)

Total demand deposits =Actual reserves×1/(Reserve ratio)

=400×1/(1/10)

= Rs. 4000million

Total money supply = Total demand deposits + Currency held by the public

= 4000 + 1200

= Rs. 5200million (3 marks)

b) If the legal reserve ratio increases to 25% and the currency held by the public remains unchanged, calculate the maximum possible amount of total money supply when full credit creates is completed. (02 marks)

Maximum amount of bank deposits $= \text{Actual reserves} \times \frac{1}{\text{Reserve ratio}}$

$= 400 \times \frac{1}{0.25}$

= Rs. 1600 million

Total money supply = Total demand deposits + Currency held by the public

= 1600 + 1200

= Rs. 2800million

7.

i. Explain the difference between deflation and disinflation. (02 marks)

Deflation

- Deflation is the economic term used to refer to a continuous reduction in general price level. (01 Mark)
- Deflation can be seen in a business cycle during contractionary period.

Disinflation

- Disinflation refers to a situation where there is a tendency that rate of increasing general price level slow down.
- In other wards disinflation refers to the decrease in the rate of inflation.
- During a disinflation even though there is an inflation rate at which GPL increases come down.
    - Ex;- 10%, 8%, 5%, 3%

ii. Distinguish between money market and capital market (3 marks)

- Money market is the market in which short term (one year or less) funds are transacted between surplus unit and deficit unit of financial market using short term financial instruments (treasure bills, re-purchase agreements, saving deposits etc.) those of which maturity period is one year or less. (1 ½ mark)
- Capital market is the market in which long term (more than one year) funds are transacted between surplus unit and deficit unit of financial market using long term financial instruments (treasure bonds, company shares, debentures. etc.) those of which maturity period is more than one year. (1 ½ mark)

iii. What are the 2 concepts presented in order to highlight the primary causes related to cost-push inflation? Explain (4 marks)

Wage push inflation

Wage push inflation is caused by increased costs as a result of higher wages demanded by trade unions and labourers. In such situations the increase in wages are not offset by increase in productivity. Therefore the costs rise, which will result in higher prices for goods produced. Thereby AS shifts to left.(2 marks)

Profit push inflation

Wage push inflation is caused when suppliers increase the prices of goods in a higher rate than the increase in their costs, in order to increase the profit margin. It will result in higher prices for goods produced. Thereby AS shifts to left.(2 marks)

iv. What are the factors those should be considered when converting other financial assets into perfect liquid asset? (2 marks)

Convenience

Cost of conversion

Certainty of value

v. **What are the key roles performed by the Central Bank of Sri Lanka in establishing financial system stability? (05 marks)**

- Promoting and maintaining public confidence in money.
- Promoting safety and soundness of individual financial institutions.
- Ensuring public confidence in financial system, in collaboration with other financial regulators, through minimization of risks to the financial system.
- Acting as lender of last resort.
- Resolving failing financial institutions in a manner that minimizes possible adverse implications of such an event on the overall financial system/economy.
- Regulating and supervising financial market infrastructure.

vi. **What are the factors that can limit credit creation? (4 marks)**

1. Money leaking out from the commercial banking system, to other non- commercial banking financial institutions.
2. Money leaking out from the commercial banking system, when people hold currency balances, without depositing Cheques received in the commercial banking system.
3. Commercial banking system holding excess reserves exceeding the mount of statutory reserves.
4. Not having enough credit demand.