2002 – ECONOMICS - I / Part -I

(1) ii/iii	(5) ii/iv	(9) i/ii	(13) i/iii	(17) iii
(2) i/iii	(6) ii/iii	(10) i/ii	(14) I =100	(18) iii
(3) ii/iii	(7) ii	(11) ii	(15) Y=1600	(19) ii
(4) i/ii	(8) ii	(12) ii/iv	(16) S,T,M	(20) iv

2002 – ECONOMICS - I / Part -II

01. (i) It is often said that an invisible hand operates in market economy. In a market economy demanders and suppliers make decisions on buying and supplying of goods after considering their private costs and benefits. Demanders always try to maximize their satisfaction while suppliers are concerned of maximizing their profits. Prices of goods and services are decided in the market based on the decisions make by these two parties (buyers and sellers). That is called price system. This price decides what to produce? How much to produce? and for whom to produce? in a market economy. This price coordinates the decisions made by consumers and producers. Therefore price is an invisible hand operated in a market economy.

This statement suggests that consumer is the main player operating the market economy. But a market economy is functioned by the price system. Price is determined by the interaction of both demand and supply. Hence, market is equally important for both consumers and suppliers. Therefore price and quantity is decided by matching the decisions made by the consumers and producers. Further producer's decisions become more powerful than consumer's decisions when there are monopolies. Hence, it is partially correct to say that there is consumer sovereignty in a market economy.

China	Bulgaria
Vietnam	Rumania
Poland	Czech Republic
Hungary	Slovakia
Mongolia	Albania
Russia	Armenia

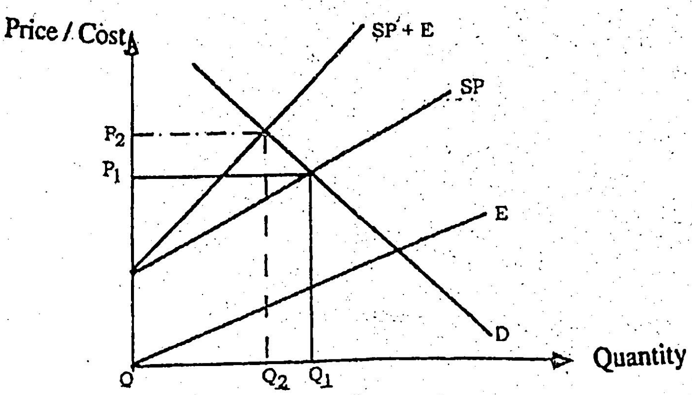
Any country that broke-away from former Soviet Russia. E.g. Lithuania ,Ukraine .

02. (i) Externalities of production refers to costs imposed or benefits accrued to those who are not directly involved with that production activity? These costs or benefits do not get included in the production cost or price. These are outside the market.

Costs imposed on the whole society from a production activity are called social cost while benefits accrued to the whole society from a production activity are called social benefits. Social costs are referred to as negative externalities and social benefits are referred to as positive externalities. Price system is incomplete since external costs and external benefits are not included in the price. That is, producers take in to account only the private costs and benefits when making decisions rather than social costs and social benefits. Hence market price will include only the private costs. Hence the output is not optimum if only private cost is considered without considering the social cost, which includes external cost.

(iii)

D=Market Demand Curve
E=External Cost
SP=Private Cost
SP+ E = Social Cost

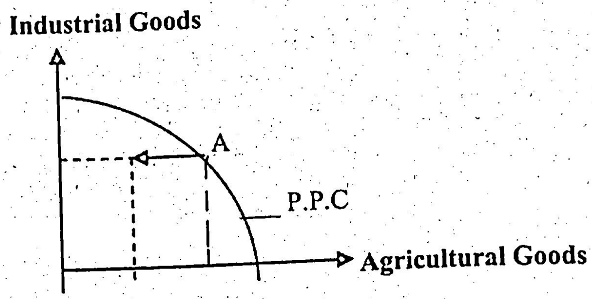


As per the above diagram P_1 is the price decided by the market demand curve and the supply curve based in the private cost. Q_1 is the equilibrium quantity corresponding with P_1 price.

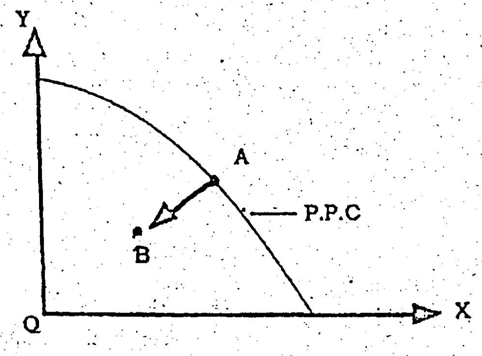
But the social cost curve which includes both external cost and private cost should lie above the private cost curve, If we consider the social cost, equilibrium price should rise up to P2 and output should decline to Q_2. Hence it can be deduced that the economy is producing more than the socially desirable level of output when there are externalities.

In the above diagram socially desirable output is Q_2 while the economy is producing Q_1 output since external cost is ignored. Any point lying within the curve and at that point only the agriculture production should have fallen leaving the indusial production at the same level.

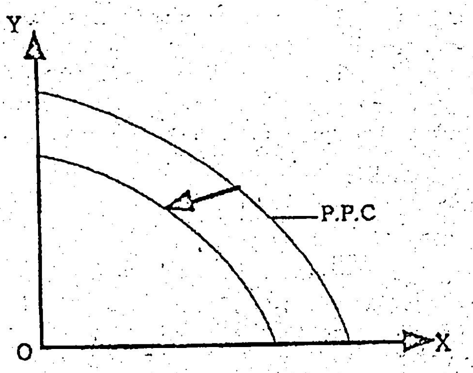
(3) (i) Any point plotted inside the curve.



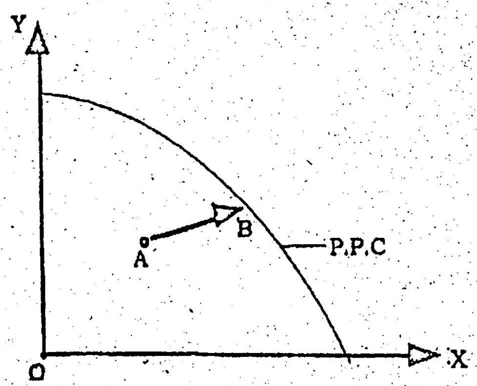
(ii) Decline in the production of both the products. Point inside the curve.



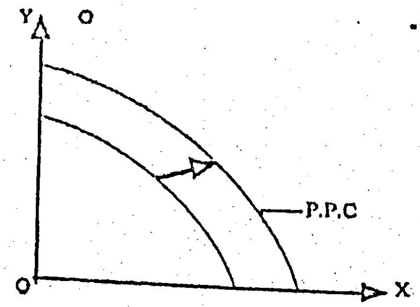
(iii)Curve shifts to its left due to the decrease in capital.



(iv). A point moves towards the curve from an inside point.



(v). Curve shifts to the right.

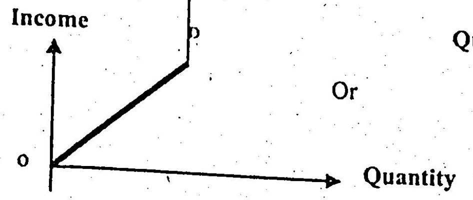


(04) (i) (a) Existence of more stocks.
The more stocks may create the supply more elastic.

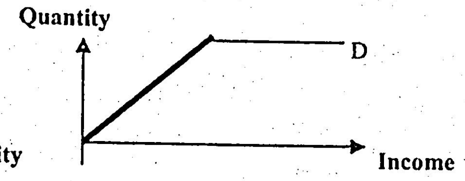
(b) Mobility of resources among industries.-This shows how easy it is to move resources from one production unit to another.

(c) The time period
This shows how easy it is to increase the supply.

(ii)



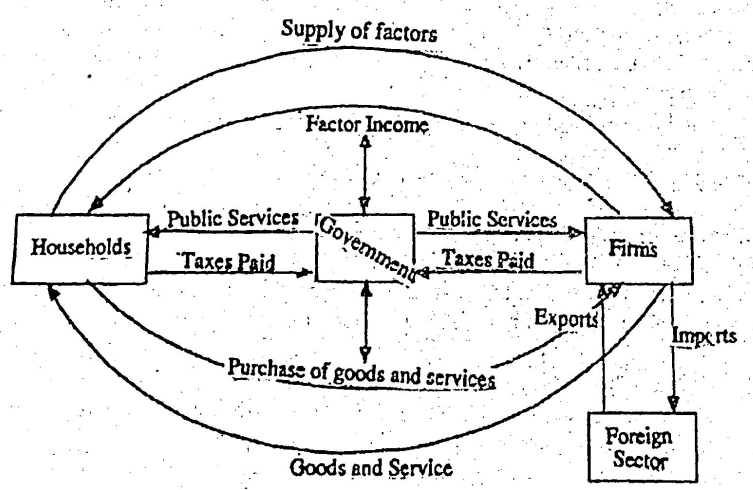
Or



Demand for luxury goods and normal goods increases as income rises. Income elasticity of demand will be positive; Demand will remain unchanged for essential goods regardless of rise in income. Even if the income rises there is no change in demand for essential goods. Income elasticity will be zero in that case.

(iii) - To measure the inter-relationship that exists between products.
Useful in devising economic policies.
To determine the degree of monopoly power.

(05) (i) Household, Business firms, Government, Foreign sector.
(ii) Household sector supplies factor services to business firms and the government.
- Business firms combine these factors and supply goods and services to the households and the government to earn an income.
- The government imposes taxes on the households and business firms.
- Further the government provides public service to both household and business firms.
- Business firms export and import goods and services.



(6) (i) The diagram depicts a graph corresponding with the $C = a + bY$ consumption function. a is the intercept of consumption curve. b, is the slope or gradient of the curve. That is, change in consumption relative to the change in income. Gradient or slope of the consumption curve is equal to MPC.

(ii) The above graph shows the equilibrium level of income, given the fixed amount of investment and $C = a + bY$ consumption function. First $Y = E$ reference line has been drawn with 45^0 angle and then the aggregate expenditure line is drawn by adding both consumption (C) and (I). Equilibrium level of income is decided at the point where aggregate expenditure (E) line intersects with $Y = E$ line. That is, Point R in this simple economy. Hence equilibrium level of income is Y1

(iii) S = I when Y = E. it is shown in the diagram (ii).
Here the savings function should be found based on the given consumption function.
Since, there is autonomous consumption (consumption at zero income level.) there will be no savings to that extent.

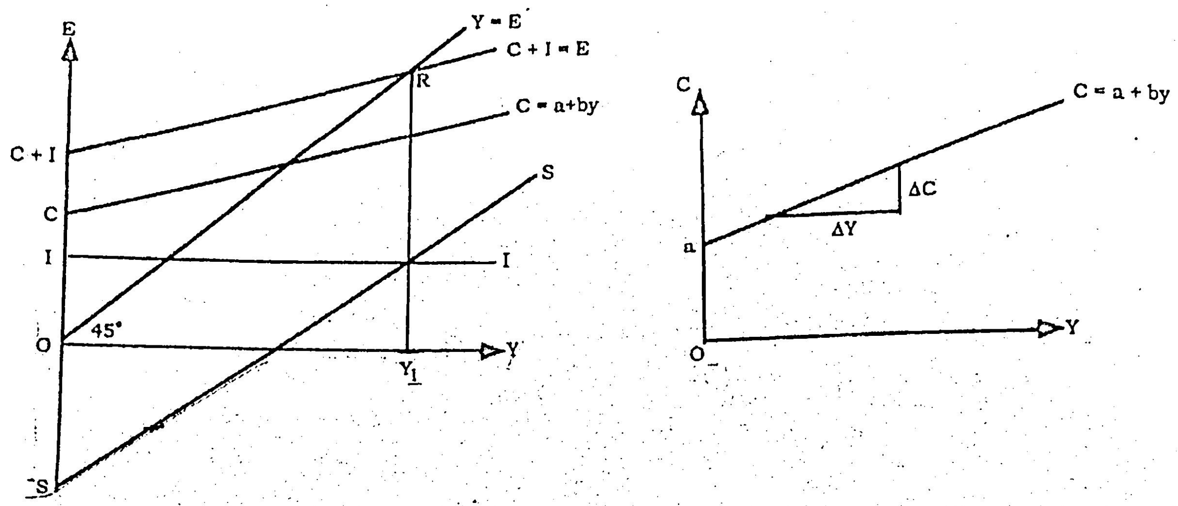


Diagram-II Diagram-I

Therefore savings functions should start with negative intercept and the gap between the origin and the intercept of the savings curve should be as same as the gap between the origin and the intercept of the consumption curve. (OC =OS).

In a simple economy only injection is investment and it is assumed to be fixed in this economy. Savings is the withdrawal. Therefore if we follow the injections equal withdrawals approach, intersecting point between investment line and savings line will decide the equilibrium level of income. That is Y_1.

(07) (i) Reducing the disparity in income distribution of a country is referred to as equity. That is parity or equal distribution of income among people. Then everyone in the population can enjoy the same level of living standard.

(ii) Progressivity should be introduced in to the tax system to ensure equity. There should be equal tax burden on people of same income and the tax burden should be changed to suit the different income levels. A good tax system should have horizontal equity, in the sense people in the same circumstances pay the same amount. It should also have vertical equity, in the sense taxes should be fair in terms of rich and poor.
E.g.:- Imposing progressive taxes on income and wealth and Domestic income tax.
This can be introduced in relation to goods and services tax. Essential goods can be exempted from taxes or reduce the taxed being charged on essential goods. Further, a higher tax can be charged on goods and services, which are generally consumed by high-income earners. Accordingly progressive tax can be introduced to the goods and services taxes.

(iii) (a) Revising the public expenditure structure to give more benefits to low income earners (poor people)
(b) Including expenditures, which are more beneficial for the poor.

(08) (i) Public budget deficit was around 7.5% to 10% during the period 1998-2000.
1998 = 9.2%, 1999 = 7.5%, 2000 = 9.9%, 2001 = 10.9%
This budget deficit was mainly financed through debts. Hence debts as a percentage of G.D.P. rose up to 97% in 2000 from 91% in 1998. Public debt as a percentage of GDP from 1998 to 2001 was as follows.
1998 – 91%, 1999 – 95%, 2000 – 97%, 2001 – 103.6%

(ii) (a) About 28% to 30% of the current public expenditure will be devoted on interest payments.
(b) Interest rates will be at a higher level due to the growth of public debt.
(c) There will be a massive debt repayment burden on future generation.

2002 – ECONOMICS - II / Part -I

(1) ii	(5) i/ii/iii	(9) ii	(13) i/ ii	(17) ii
(2) iv	(6) i	(10) ii/iii	(14) iii	(18) i
(3) i/ii	(7) ii	(11) iii	(15) i/iv/v	(19) ii/iii
(4) i/iii	(8) ii	(12) iii	(16) iii	(20) iii/iv/v/vi/ix

(1). (i) Broad money results when near money is added to narrow money.
- Near money includes a range of assets with different levels of liquidity rather than a single homogenous asset.
- Near money includes assets such as savings and term deposits of commercial banks, savings and term deposits of banking financial institutions, short term commercial bills etc.
- Various types of broad money result depending on the type of near money being added to narrow money. (M2, M3, M4).

ii As a measure of economy's liquid assets, it is important in devising economic policies (financial/ monetary, fiscal policy) since liquid assets affect the expenditure made on goods and services of the economy.

iii Transaction motive (To meet day today expenses)
- Precautionary motive (To be used in an emergency)
- Speculative motive (To make gains out of future favourable movements)

(2.) (i) Increasing the reserve requirement for commercial banks (Raising statutory reserve Ratio (SRR) of Commercial Banks)
- Increasing the bank interest rate.
- Sale of securities in the open market by the Central Bank.
- Decreasing demand for credit

(ii) Investments can get discouraged due to increased cost of loans
- Savings become attractive
- Less speculative
- Inflation can result due to increased production cost
- Increased government current expenditure due to the rise in interest payment on public debt. It can affect government budget deficit

(iii) Money flows to the market from the Central Bank
- The amount of money held by Commercial Banks and private sector increases.
- A certain portion of that money is deposited in Commercial Banks and as a result their credit creating ability improves. It causes an increase in money supply

(3) (i) Imports become cheaper relative to domestically produced goods since price of domestic goods are higher in inflation.
Demand for imports will rise when imports become cheaper. Here we assume that world inflation rate is constant.

(ii) Prices of exports will go up. This is because production cost of exports will rise due to inflation.
- International competitiveness of exports will fall since exports are expensive.

(iii) - Quantity of imports that can be purchased under prevailing nominal exchange rate increases when foreign inflation becomes higher than domestic inflation.
This is similar to a rise in real effective exchange rate. Here although nominal effective exchange rate falls, real effective exchange rate rises. And also this is similar to an appreciation of exchange rate.

(4.) (i) Production and income of the country increase due to the fact that country can export relatively low cost goods and import relatively high cost goods.
- Can attain a product combination lying outside the production possibility curve.
- Goods, which cannot be produced locally, can be consumed. This leads to a variety in consumption.
- Can enjoy benefits of international specialization
- Market will get expanded
- Can employ resources efficiently
- This is important for the economic growth since trade is a growth mechanism

(ii) - Rate of effective protection =

$$\frac{\text{Value added per unit of good under tariffs} - \text{Value added per unit of good under free trade}}{\text{Value added under free trade}} \times 100$$

This can be illustrated using a numerical example. A unit of good can be imported for Rs. 10/- under free trade. When 20% duty is imposed on the good, imported price becomes Rs. 12/- Let us assume that price per unit of input is Rs. 8/- Accordingly,

Rate of effective protection $= \frac{(12\text{-}8) - (10\text{-}8)\text{x}10e}{(10\text{-}8)}$

$= 4 - 2 \text{x}100/2$

$= 100\ \%$ //

20% tariff has given 100% protection. This is because there is no tariff on inputs. When 10% duty is imposes on inputs, price per unit of input becomes Rs. 8.80. Then,

$$\text{Rate of effective protection} = \frac{(12-8.80)-(10-8.80)\times 100}{(10-8.80)}$$
$$= \frac{3.20-1.20 \times 100}{1.20} = 500/3$$
$$= 166.66\% \text{ //}$$

Rate of effective protection has become 166.66%. When there is tariff on inputs.

iii Production cost - More recourses should be used per unit of good
Cost of consumption - Price to be paid by the customer increases.

(5.) i An unemployed person is defined as one who remains without paid work even though he is willing to work for pay, or any other economic/ financial benefit. Underemployment refers to a situation where, the person is not having enough work to fully employ himself or the person is engaged in less productive work. The work / job, the person is engaged in is not suited to his qualifications and training. Therefore, the person is in a low income position.

ii Labour resources get underutilized due to underemployment
- Resources are wasted
- This causes poverty
- This results in less production

iii The unemployment rate had declined in the recent past
The unemployment rate among the educated youth has declined (Decline in unemployment among the higher educated was evident from the relatively higher decline in the unemployment rate for the G.C.E (O/L) and the G.C.E. (A/L) and higher qualified categories from 17.3% in 2002 and to 15.2% in 2003)
The lack of the required educational qualifications and skills for the current industries has been a key reason for youth unemployment. Unemployment among youth is high. In 2002 unemployment in the age group 15-19 and 20-29 is about 30%.

(6.) (i) Economic growth is an essential requirement for development. This is because,
- Country's production capacity increases in an economic growth leading to a change in the economic structure through the income elasticity behaviour of the economy. People's ability to satisfy needs improves in an economic growth and as a result an increased amount of goods and services can be consumed.
- Standard of living of people is being improved in an economic growth
- Service sector gets expanded in an economic growth and it increases employment in that sector
- Household income increases in an economic growth.

(ii) Distribution of the benefits of economic growth evenly among the population.
Disparity in income distribution should be reduced.
Poverty should be reduced
There should be an improvement in education, healthcare, sanitary services and drinking water along with economic growth

(iii) Encouraging labor intensive industries to generate more employment opportunities.
Introducing a progressive tax system to reduce income disparity and restructuring public expenditure to provide more benefits to poor.
Providing loans and necessary training to poor people who possess entrepreneurial skills
Direct involvement by the government in supplying facilities such as education, healthcare etc.

(7.) i Per capita national income is normally used for making international comparisons. Per capita national income is converted in to dollar terms at current exchange rate in order to make comparisons. Current exchange rate is determined in the Foreign exchange market according to the demand and supply of foreign currencies. Hence a proper comparison of purchasing power of income cannot be made between countries using the exchange rates that exist in different countries.

ii. Per capita national income based on purchasing power parity is used to obtain a more realistic picture of the income gaps that exist among countries. Purchasing power parity (PPP) is the comparison of purchasing power of income between two countries. Here we consider how much money in rupees we have to spend to purchase the same basket of goods, which can be purchased per unit of dollar in USA. That becomes the exchange rate of dollar.

iii. Per capita income of Sri Lanka in 2000 under current exchange rate is US $.841 and that of US is US $34260. Accordingly income gap between two counties is more than 40 times. But per capita income of Sri Lanka in 2000 under purchasing power party exchange rate is US $3470. In this case the income gap between Sri Lanka and USA is less than 10 times. Accordingly it is clear that per capita income calculated under PPP gives a more realistic picture of the income gaps.

(8.) (i) Growth in production

Growth of real gross domestic production is 6% in 2000. In 200I it took a negative figure. Mainly production industries, wholesale, retail trade and transport contributed to the growth in output in 2000

(ii) Price level

About 6% annual growth was recorded in 2000. Colombo Consumer price index showed 6.2% and Gross National product implicit Price index showed 6.7%

(iii) Government budgetary operations

Overall budget deficit as a percentage of GDP is 9.9%
Deficit in current account is 3.4%
Deficit has mainly been financed by loans
Public debt as a percentage of GDP is 97% in 2000
Interest on public debt as a percentage of current expenditure is 28%

(iv) Balance of payment and exchange rate

There is a deficit in BOP.
Foreign currency reserves (Foreign assets) is enough only for 3.5 months imports
Nominal Effective Exchange Rate was depreciated by 6.8%
Real Effective Exchange Rate was appreciated by 0.6%