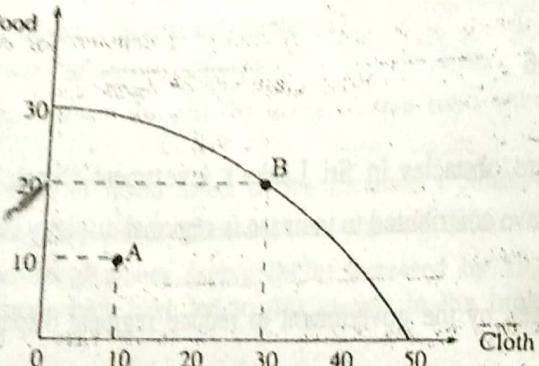


General Certificate of Education (Adv. Level) Examination, August 2007  
 Economics 1 (Part I) One hour

Index No. :

- Note: \* There are 20 questions in this Part and all questions are compulsory.  
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- A "free good" in economic terms can best be described as one which
  - is supplied at a zero price to the consumer.
  - is provided free by the government.
  - does not use scarce resources in its production.
  - is extracted directly from the land or sea.
  - can be produced at constant opportunity cost.
- The diagram below shows the production possibilities frontier of an economy.



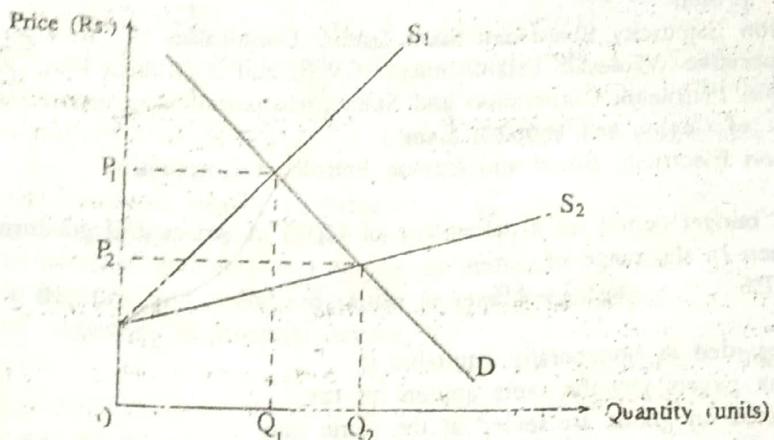
The opportunity cost of moving from point A to point B is

- 20 units of cloth.
- zero.
- 10 units of food.
- $\frac{1}{2}$  unit of cloth per one unit of food.
- 30 units of cloth and 20 units of food.

- One reason why there are mixed economies is that
  - the free market economy allocates resources efficiently.
  - the profit motive acts as a disincentive to new businesses to enter an industry.
  - competition is always undesirable.
  - the free market economy can lead to an unequal income distribution.
  - labour productivity is low in free market economy.

4. The demand curve for rice is downward sloping. If the demand for rice is price inelastic, a reduction in the price of rice must result in  
 (i) excess supply of rice.  
 (ii) an increase in the quantity demanded for rice.  
 (iii) an increase in total expenditure on bread.  
 (iv) increased sales of wheat flour.  
 (v) an increase in total expenditure on rice.

5.



The change of the supply curve from  $S_1$  to  $S_2$  in the above diagram could be caused by

- (i) an increase in the demand for the good.
- (ii) a reduction in the rate of *ad valorem* tax imposed on the good.
- (iii) an increase in the rate of *ad valorem* tax imposed on the good.
- (iv) a reduction in the unit tax imposed on the good.
- (v) an increase in the cost of raw materials used in the production of the good.

6. The following information gives details of the price elasticity of demand for certain goods and services.

Item	Price elasticity of demand
Motor cars	- 1.5
Motor cycles	- 1.0
Cinema tickets	- 0.4
Boxes of matches	0.0

An increase in the price of each item by 1% would result in an increase in sales revenue in the case of

- (i) motor cars only.
- (ii) motor cars and motor cycles only.
- (iii) cinema tickets and boxes of matches only.
- (iv) cinema tickets only.
- (v) boxes of matches only.

12. Which one of the following describes merit goods and public goods correctly?

Merit goods	Public goods
(i) Provided by government	Provided by private companies
(ii) Provided at a cost	Provided at no cost
(iii) Limited in supply	Have an infinite supply
(iv) Consumption reduces availability	Consumption does not reduce availability
(v) Price cannot be charged	Price can be charged

13. Identify the two public enterprises, which pose highest financial burden on government fiscal operations in Sri Lanka at present.

- (i) Ceylon Electricity Board and State Timber Corporation
- (ii) Cooperative Wholesale Establishment (CWE) and Sri Lanka Ports Authority
- (iii) Ceylon Petroleum Corporation and State Pharmaceuticals Corporation
- (iv) Bank of Ceylon and People's Bank
- (v) Ceylon Electricity Board and Ceylon Petroleum Corporation

14. The overall budget deficit (as a percentage of GDP) of the central government of Sri Lanka in the recent years has been in the range of (i) 6 - 7% (ii) 7 - 8% (iii) 8 - 9% (iv) 10 - 11% (v) 11 - 12%

15. Taxes are regarded as horizontally equitable if

- (i) all tax payers pay the same amount of tax.
- (ii) all taxes on goods are levied at the same rate.
- (iii) taxes are as low as possible.
- (iv) the system comprises only lump sum taxes.
- (v) tax payers with similar abilities to pay the same amount of taxes.

16. Which one of the following is most likely to lead to an increase in aggregate demand?

- (i) An increase in savings
- (ii) An increase in imports
- (iii) An increase in government tax revenue
- (iv) An increase in investment
- (v) An increase in the rate of interest

17. Net Domestic Product at market prices equals

- (i) Consumption + Government purchases + Net exports + Investment expenditures.
- (ii) Consumption + Government purchases + Exports + Personal taxes.
- (iii) Indirect business taxes + Personal income taxes + Net exports.
- (iv) All domestic factor incomes + Indirect taxes - subsidies.
- (v) All factor incomes - Depreciation.

18. If a cobbler buys leather for Rs. 1,500 and thread for Rs. 200 and uses them to produce and sell Rs. 10,000 worth of shoes to consumers, his contribution to GDP is

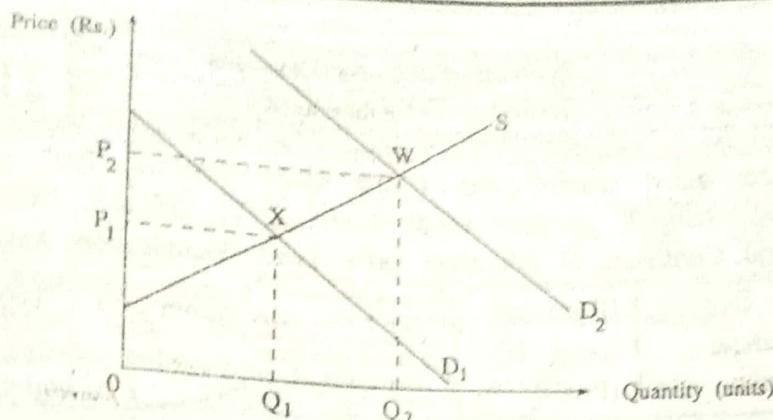
- (i) Rs. 11,750.
- (ii) Rs. 10,200.
- (iii) Rs. 10,000.
- (iv) Rs. 8,300.
- (v) Rs. 1,700.

19. In a household with annual disposable income of Rs. 60,000 and consumption expenditure of Rs. 45,000 means its

- (1) Marginal Propensity to Consume (MPC) is 0.25
- (ii) Marginal Propensity to Consume (MPC) is 0.75
- (iii) Average Propensity to Consume (APC) is 0.25
- (iv) Average Propensity to Consume (APC) is 0.75
- (v) Marginal Propensity to Save (MPS) is 0.25

20. In the income range where the consumption function lies below the 45° line, households

- (i) consume all of any increase in their income.
- (ii) consume more than their disposable income.
- (iii) will be saving some portion of their income.
- (iv) save all of any increase in their income.
- (v) are dissaving.



The diagram above shows the effect of an increase in demand for fish in a competitive market. This will cause

- (i) producer surplus and consumer surplus to increase.
- (ii) producer surplus and consumer surplus to decrease.
- (iii) producer surplus to decrease and consumer surplus to increase.
- (iv) producer surplus to increase and consumer surplus to remain unchanged.
- (v) no change in either consumer or producer surplus.

8. Economic rent is

- (i) a payment for the use of the land.
- (ii) the income that must be paid to factors of production in order to keep them in their present employment.
- (iii) a payment that must be made to the central government for the use of government services.
- (iv) a compensation for the opportunity cost of the resources.
- (v) payments to factors of production in excess of what would keep them from changing employment.

9. If there are implicit costs of production,

- (i) accounting profit will exceed economic profit.
- (ii) economic profit will always be zero.
- (iii) economic profit will exceed accounting profit.
- (iv) accounting profit will always be zero.
- (v) economic profit and accounting profit will be equal.

10. A consumer survey reveals that a 20% increase in the price of an alcoholic drink would reduce consumption of the rich by 3% and consumption of the poor by 10%. It can be deduced from this that

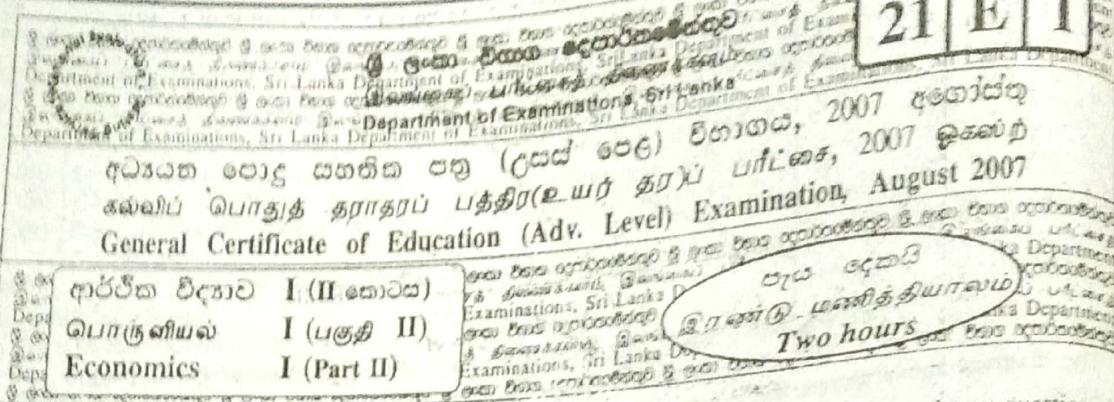
- (i) the rich enjoy the alcoholic drink more than the poor.
- (ii) for the rich, the alcoholic drink is an inferior good.
- (iii) for the poor, the alcoholic drink is a normal good.
- (iv) the demand of the poor is price elastic while that of the rich is price inelastic.
- (v) demand is price inelastic for both the rich and the poor.

The following information refers to a short run total variable cost schedule of a perfectly competitive firm.

Output	Total variable cost (Rs.)
1	5
2	20
3	40
4	70
5	110
6	160
7	220

The marginal cost of the 5th unit of output is

- (i) Rs. 30
- (ii) Rs. 40
- (iii) Rs. 55
- (iv) Rs. 90
- (v) Rs. 110

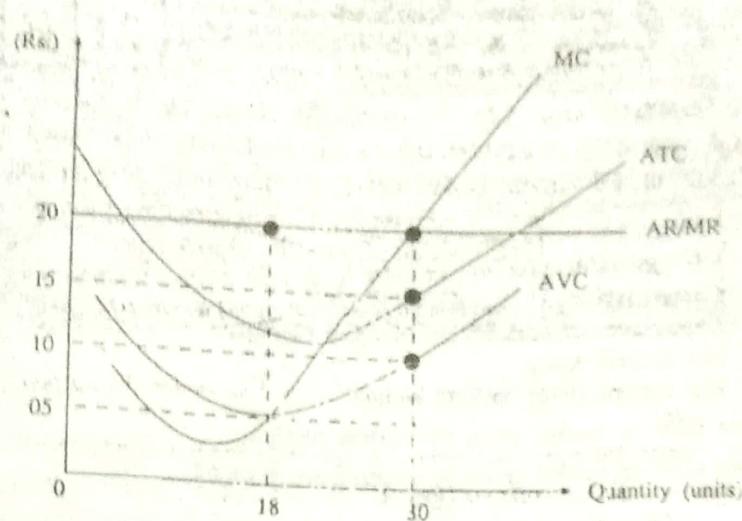


Sub-section A

(Select two questions from this Section.)

1.
  - (i) What are the three basic economic questions? (03 marks)
  - (ii) How are the decisions on basic economic questions made differently in a market economy than in a planned economy? (04 marks)
  - (iii) How would the following events be shown using a production possibilities frontier for food and cloth?
    - (a) The economy is experiencing a recession.
    - (b) Economic growth takes place.
    - (c) Society decides it wants more food and less cloth.
    - (d) Technological advance takes place in food production sector
  - (iv) Why are most production possibilities frontiers bowed outward or concave to the origin? Explain reasons. (04 marks)
  
2.
  - (i) What is the role of prices in market economies? (03 marks)
  - (ii) What mechanism allocates resources when the price of a good is not allowed to bring supply and demand into equilibrium? (02 marks)
  - (iii) What determines the quantity of a good that buyers demand? (04 marks)
  - (iv) Why does an increase in price reduce the quantity demanded? Give two reasons and explain your answer. (06 marks)
  
3.
  - (i) What are the characteristics of a perfectly competitive market?
  - (ii) Categorise the following industries in Sri Lanka according the main types of market structure:
    - (a) soft drinks
    - (b) railway
    - (c) TV broadcasting
    - (d) grocery stores
    - (e) paddy cultivation
    - (f) barber shops

- (ii) The graph below illustrates the cost and revenue structure facing a perfectly competitive firm in the short run.



- (a) If the market price is Rs. 20 per unit, calculate the total economic profit of the firm. (05 marks)  
 (b) What is the lowest price at which a firm produces an output in the short run? Explain why. (04 marks)

4. In a competitive rice market, the demand and supply schedules of rice are given below:

Price (Rs. Per kg.)	Quantity Demanded (million kgs.)	Quantity Supplied (million kgs.)
0	120	40
10	100	20
20	80	0
30	60	20
40	40	40
50	20	60
60	0	80

- (i) What are the equilibrium price and quantity in the rice market? (02 marks)  
 (ii) If a subsidy of Rs. 20 per kg. is introduced what would be the new equilibrium price and quantity in the market? Draw a diagram to explain your answer. (04 marks)  
 (iii) What is the total cost of the subsidy to the government? (04 marks)  
 (iv) Estimate the producer surplus after the subsidy. (05 marks)

### Sub-section B

(Select two questions from this Section.)

- (i) Indicate how each of the following activities which occurred in a certain year will affect that year's GDP:  
 (a) Rs. 120,000 of income earned by a clerk working at organization in the private sector  
 (b) A person wins Rs. 200,000 in a state lottery  
 (c) A cyclone that causes damage to houses worth Rs. 200 million  
 (d) A payment of Rs. 10,000 as house rent to a landlord  
 (e) A discovery of multi-million rupees worth of petroleum deposits in North sea close to Mannar (05 marks)

(ii) You are given the following macroeconomic data about a hypothetical economy (values in Rs. Billions):

Net exports	10
Rents	20
Personal consumption expenditures	400
Interest	30
Dividends	45
Undistributed corporate profits	5
Corporate income taxes	10
Government purchases	100
Net private domestic investment	50
Compensation of employees	400
Depreciation (Consumption of fixed capital)	10
Net indirect taxes	50
Net foreign factor income earned	10

(a) Calculate GNP at market price by income method.

(b) Calculate GNP at market price by expenditure method.

(05 marks)

(05 marks)

6. (i) A macroeconomic model for a hypothetical economy is represented by the following equations:

$$C = 1000 + 0.75Y \quad (\text{Consumption function})$$

$$I = 500 \quad (\text{Investment})$$

$$G = 600 \quad (\text{Government purchases})$$

$$NX = -300 \quad (\text{Net exports})$$

(a) What is the total value of autonomous expenditures in this model?

(02 marks)

(b) Determine the equilibrium income level for this economy.

(05 marks)

(c) What is the value of the multiplier?

(03 marks)

(ii) Consider the following macroeconomic data for a closed economy which is in equilibrium:

$$Y = \text{Rs.} 14 \text{ billion; (Gross Domestic Product)}$$

$$C = \text{Rs.} 7 \text{ billion; (Consumption)}$$

$$I = \text{Rs.} 3 \text{ billion; (Investment)}$$

$$TR = \text{Rs.} 1 \text{ billion; (Transfers)}$$

$$T = \text{Rs.} 3 \text{ billion. (Direct Taxes)}$$

Using the above data calculate the following:

(a) Disposable Personal Income

(01 mark)

(b) Private savings

(01 mark)

(c) Public savings

(01 mark)

(d) Government purchases

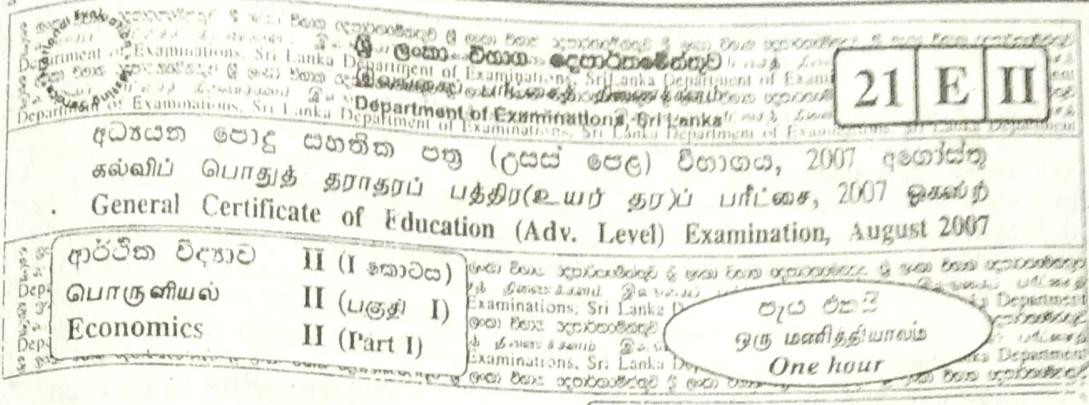
(01 mark)

(e) Total withdrawals

(01 mark)

7. (i) Using examples, explain (a) external costs and (b) private costs. (04 marks)
- (ii) Graphically illustrate (a) a negative externality and (b) a positive externality in consumption. (04 marks)
- (iii) Explain why markets may fail to provide public goods and under-provide merit goods. (04 marks)
- (iv) What is meant by government failure? (03 marks)

8. (i) Explain the main economic reasons for government spending. (04 marks)
- (ii) What are the important features of a desirable tax system? (04 marks)
- (iii) What is meant by primary deficit of government budget? (02 marks)
- (iv) Outline the main sources of financing budget deficit and their economic implications in Sri Lanka in recent years. (05 marks)



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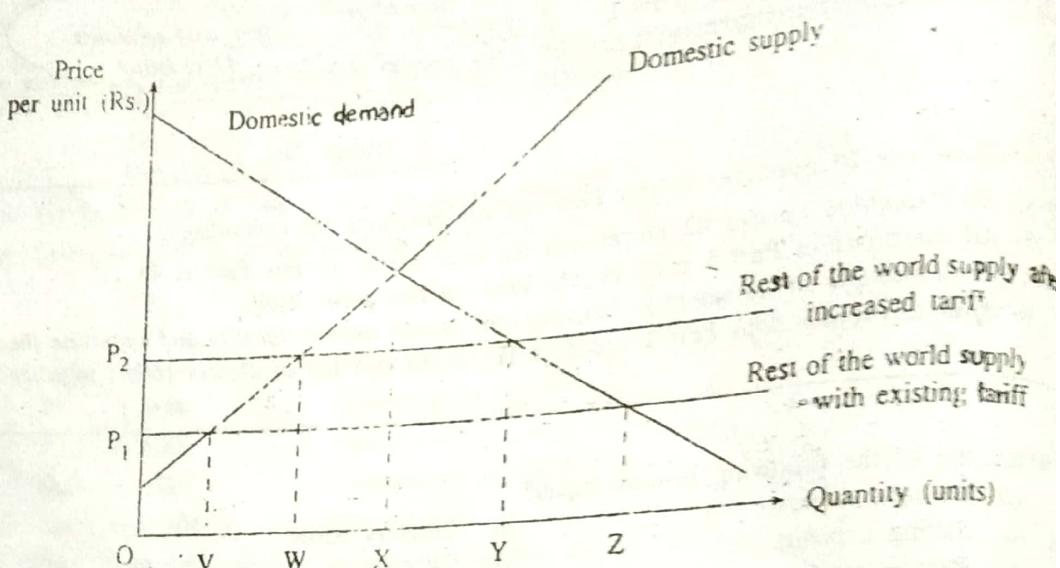
1. Which one of the following is most liquid?
    - Demand deposits
    - Treasury bonds
    - Saving deposits
    - Cheques
    - Real estate
  2. Suppose you deposit Rs. 2,000 in a demand deposit account at one of the commercial banks in the banking system. The bank wishes to hold 20% of all deposits on reserve. What would be the amount of new deposits created by this bank as a direct result of your deposit?
    - Rs. 200
    - Rs. 400
    - Rs. 1,600
    - Rs. 8,000
    - Rs. 10,000
  3. Money makes it easier to borrow and repay loans. This function of money is referred to as
    - a store of value.
    - a means of deferred payment.
    - a unit of account.
    - a standard of value.
    - medium of exchange.
  4. The quantity of money that households and business will demand
    - increases if income rises but decreases if interest rates rise
    - increases if both income and interest rates rise.
    - decreases if income rises but increases if interest rates rise.
    - decreases if both income and interest rates rise.
    - remains unchanged if income rises but decreases if interest rates rise.
  5. Suppose the central bank purchases Rs 100 million of securities from the open market. If the reserve requirement is 20% and all banks keep zero excess reserves, the total impact of this action on the money supply will be a
    - Rs 100 million decrease in the money supply.
    - Rs 500 million decrease in the money supply.
    - Rs 100 million increase in the money supply.
    - Rs 200 million increase in the money supply.
    - Rs 500 million increase in the money supply.

6. If the nominal interest rate is 16% and the inflation rate is 20%, the real interest rate is  
 (i) - 4% (ii) 4% (iii) 16% (iv) 20% (v) 36%

7. Which one of the following is a cause of demand-pull inflation?

- (i) A sharp increase in the price of oil.
- (ii) Higher wages negotiated by trade unions.
- (iii) Open market purchases of government securities by the Central Bank
- (iv) Open market sales of government securities by the Central Bank
- (v) A decrease in government purchases of goods and services

8.



The diagram above represents domestic market for a good. When the existing tariff on the imports of good is increased, the import price of the good rises from  $OP_1$  to  $OP_2$ . The effect of higher tariff would be to reduce the quantity of imports by

- (i)  $VW$
- (ii)  $WY$
- (iii)  $XZ$
- (iv)  $(VZ) - (WY)$
- (v)  $(VZ) - (VX)$

9. In a floating exchange rate system

- (i) the government intervenes to influence the exchange rate.
- (ii) the exchange rate should adjust to equate the supply and demand of foreign exchange.
- (iii) the balance of payments should always be in surplus.
- (iv) the balance of payments will always equal the government budget.
- (v) the external value of the currency would always tend to rise.

10. The following table shows the hypothetical data on the amount of output a worker can produce per hour in India and Bangladesh:

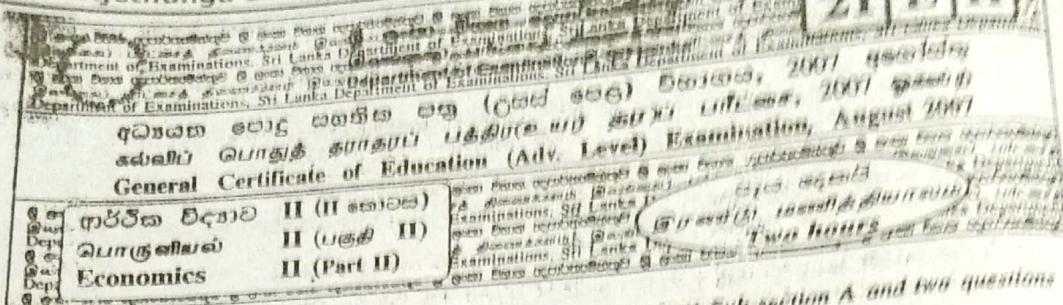
Country	Pens	Pencils
India	8	4
Bangladesh	8	2

Which one of the following statements about free

- (i) India will export pencils and Bangladesh will export pens.
- (ii) India will export pens and Bangladesh will export pencils.
- (iii) India will export both pens and pencils.
- (iv) Bangladesh will export both pens and pencils.
- (v) India will export pencils but there will be no trade in pens because neither country has a comparative advantage in the production of pens.

11. A depreciation of the Sri Lankan rupee would  
 (i) discourage foreign tourists visiting Sri Lanka.  
 (ii) discourage foreign consumers from buying Sri Lankan goods.  
 (iii) reduce the number of rupees it would take to buy foreign currency.  
 (iv) encourage Sri Lankans to buy more foreign goods.  
 (v) encourage foreigners to buy more Sri Lankan goods.
12. A favourable movement of the terms of trade of Sri Lanka could be explained by  
 (i) a fall in Sri Lankan exports to European Union.  
 (ii) a fall in the value of Sri Lankan rupee in terms of foreign currency.  
 (iii) a surplus in the trade balance of Sri Lanka.  
 (iv) a fall in the price of Sri Lankan imports relative to the price of Sri Lankan exports.  
 (v) a rise in the value of Sri Lankan export earnings.
13. According to the World Bank's country classification, the low income countries are those with annual per capita income less than  
 (i) US \$ 675      (ii) US \$ 875      (iii) US \$ 1000      (iv) US \$ 1300      (v) US \$ 3465
14. Life expectancy at birth and adult literacy rate in Sri Lanka at present are respectively  
 (i) 76 years and 94%      (ii) 74 years and 92%      (iii) 70 years and 90%  
 (iv) 70 years and 94%      (v) 68 years and 90%
15. If all income earners in a country had the same level of income, then the value of the Gini coefficient would be  
 (i) 0.0      (ii) 0.5      (iii) 1.0      (iv) above 1.0      (v) infinity
16. Which of the following is not a component of Human Poverty Index for developing countries?  
 (i) Probability at birth of not surviving to age 40  
 (ii) Children underweight for age  
 (iii) Population without sustainable access to an improved water source  
 (iv) Adult illiteracy rate  
 (v) Population below income poverty line
- In a country with a working-age population of 130 million, 90 million workers are employed and 10 million workers are unemployed. What is the unemployment rate?  
 (i) 5.0%      (ii) 7.1%      (iii) 7.7%      (iv) 10.0%      (v) 13.0%
- Internal balance as a macroeconomic policy objective refers to  
 (i) full employment and price stability.  
 (ii) full employment and surplus in the balance of payments.  
 (iii) exports equal to imports.  
 (iv) savings equal to investment.  
 (v) price stability and exchange rate stability.
- Which one of the following best defines the concept of sustainable development?  
 (i) Achieving the highest rate of economic growth in the present as well as in the future.  
 (ii) Implementing policies that are aimed at protecting the environment.  
 (iii) Meeting the needs of the present generation without jeopardizing the capabilities of future generations to meet their own needs.  
 (iv) Eliminating the economic problem of scarcity in the future.  
 (v) Reduction of absolute poverty in the present as well as future generations.
- Members of the Organization for Economic Cooperation and Development (OECD) are  
 (i) high income industrial countries.  
 (ii) high income oil-exporting countries.  
 (iii) newly industrialized countries like Singapore and Malaysia.  
 (iv) countries with transitional economies in the Eastern Europe.  
 (v) high income countries in North America and Europe.

21 E II



*Instructions: Answer four questions only selecting two questions from Sub-section A and two questions from Sub-section B.*

**Sub-section A**

(Select two questions from this section)

- I. (i) You are given the following hypothetical data about Sri Lanka's financial systems

Item	Rs. billion
Currency held by the public	150
Currency with commercial banks	20
Commercial banks deposits with the Central Bank	80
Demand deposits held by the public with commercial banks	120
Time and saving deposits held by the public with commercial banks	600
NRFC deposits treated as domestic deposit liabilities	125
Deposits of resident category of Offshore Banking Units	75
Net foreign assets of the Central Bank	100
Deposits held by public in registered finance companies	90

Calculate

- (a) The monetary base (reserve money)
- (b) The narrow money supply ( $M_1$ )
- (c) The broad money supply ( $M_2$ )
- (d) The consolidated broad money supply ( $M_{2b}$ )

(04 marks)

- (ii) Suppose one of the commercial banks in a banking system has a simplified balance sheet as shown below:

Liabilities	(Rs. Million)	Assets	(Rs. Million)
Deposits	100,000	Reserves	22,000
		Securities	38,000
		Loans	40,000
Total	100,000	Total	100,000

- (a) If the reserve ratio is 20%, what is the maximum amount of new loans that this bank can make? (02 marks)
  - (b) Show how the bank's balance sheet will appear after the bank has lent this additional amount. (03 marks)
  - (c) How will the bank's balance sheet appear after cheques drawn for the entire amount of the new loans have been cleared against this bank? (03 marks)
- (iii) Identify three main forms of leakages of money from the banks which would dampen the money-creating potential of the banking system. (03 marks)

- (i) What are the objectives and functions of the Central Bank of Sri Lanka? (05 marks)  
 (ii) How does the Central Bank of Sri Lanka form an interest rate corridor for the inter-bank cash money market rates? (05 marks)  
 (iii) If bond prices fall, will individuals want to hold more or less money? Explain your answer (05 marks)

- (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 Phones
Norway	2	1
Sweden	4	1

- (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? (02 marks)  
 (b) Which nation has an absolute advantage in calculators, and which nation has absolute advantage in mobile phones? (02 marks)  
 (c) What is the opportunity cost of producing one calculator in each nation? (02 marks)  
 (d) What is the total or joint output if two nations specialize in the good for which they have a comparative advantage? (02 marks)

- (ii) Name two countries with which Sri Lanka has bilateral free trade agreements at present (02 marks)  
 (iii) What is the World Trade Organisation (WTO)? How does it relate to international trade? (05 marks)

- (i) Over the course of a year, a nation tracked its foreign transactions and arrived at the following amounts:

Item	Rs. Billion
Income receipts	30
Income payments	70
Merchandise imports	1,000
Privatisation proceeds	10
Private transfers (net)	200
Official transfers (net)	15
Capital transfers (net)	40
Private long term capital outflows	30
Services (net)	25
Merchandise exports	700
Private long term capital inflows	40
Foreign direct investment (net)	50
Government long term capital inflows	55
Government long term capital outflows	25

- (a) What is this nation's current account balance? (03 marks)  
 (b) What is this nation's capital and financial account balance? (03 marks)  
 (c) What is this nation's overall balance? (03 marks)

- (ii) Explain the likely determinants of exchange rates in a freely floating exchange rate system. (06 marks)

Sub-section B

(Select two questions from this Section.)

5. (i) What is meant by 'economic growth'? (02 m<sub>ea</sub>)  
(ii) Explain the main causes of economic growth. (04 m<sub>ea</sub>)  
(iii) What are the conditions necessary for economic growth to improve the quality of life? (04 m<sub>ea</sub>)  
(iv) Explain why GDP per capita comparison among nations is not a perfect measure of differences in economic well-being. (05 m<sub>ea</sub>)
6. (i) What is pro-poor growth? (05 m<sub>ea</sub>)  
(ii) How can pro-poor growth be achieved? (05 m<sub>ea</sub>)  
(iii) What measures have been taken by the government of Sri Lanka in the recent years to achieve pro-poor growth? (05 m<sub>ea</sub>)
7. "The Samurdhi programme has been the single largest welfare programme for the poor in Sri Lanka since its inception in 1995".  
(i) What are the salient features of the Samurdhi programme? (05 m<sub>ea</sub>)  
(ii) Describe the main components of the rural development programme implemented under Samurdhi. (05 m<sub>ea</sub>)  
(iii) Critically examine the major limitations of the Samurdhi programme as a poverty alleviation strategy. (05 m<sub>ea</sub>)
8. "More than 50% of the growth of GDP in Sri Lanka in the recent years has come from the service sector".  
(i) What are the main sub-sectors that belong to service sector according to the sectoral composition of GDP? (04 m<sub>ea</sub>)  
(ii) How did the share of the service sector in GDP change annually during the period 2001 – 2005? (05 m<sub>ea</sub>)  
(iii) Would further expansion of the service sector, relative to agricultural and industrial sectors, be conducive to achieve a sustainable economic growth? (06 m<sub>ea</sub>)