

6. i). - Economic growth is a persistent growth in the real or potential output in a country. (01 mark)

- Development is a process that can increase the quality of the standard of living of the people. (01 mark).
- Development should emphasize on improving the quality of the standard of living and social, economic and political environment that supports increasing the self esteem of the people. (01 mark).
- Economic growth is an essential but not a sufficient factor of economic development. (1 mark).

ii). Reducing gender inequality in accessing secondary and tertiary education.

- Reducing child mortality rate.
- Reducing mortality from Malaria.
- Reducing the percentage of households with poor access to clean drinking water.
- Reducing the percentage of households with poor access to sufficient level of sanitary facilities.

iii). - Decreasing productivity of local agricultural industry.

- Effective competencies that are suitable for the labour market are not being developed due to the lack of quality in education.
- Geographical isolation.
- Decreasing labour mobility in the estate sector.
- Unavailability of sufficient level of infrastructure facilities.
- Underemployment and hidden employment.
- Inefficiency in the poverty eradication programmes in the government.
- Poor growth in the entrepreneurship.
- Drug addiction.
- Long lasting war and conflict environment that existed in the country.
- Centralized growth mechanism in urban cities. (4 marks).

iv). - Samurdhi programme that transfer income for poor and extreme poor population.

- Provision of financial assistance to the families with disabled and dead members of the security forces.
- Community development programme that assist internally displaced people.
- Emergency aid provided for the people hit by natural disasters like floods/Tsunami etc.
- Provision of free school text books and uniforms to school children.
- Assistance given to the people who cannot engage in any productive activity due to mental or physical retardation/illnesses. (4 marks).

7.

i). Male population = 64.7%

Female population = 35.3% (2 marks).

ii). Dependency ratio (2006) = 48.3% or Dependency ratio (2003) = 49.3 %

(2 marks).

iii). Changes in the age structure of the population.

- Decreasing child dependency ration and increasing adult dependency ratio.
- Decreasing the population that belongs to year 25 – 54 age group who also belong to the labour force. (01 mark).
- Influence of the economic growth
- As the pensionable population increases the government needs to allocate more funds for pensions thus creating deterioration in the economic growth.
- The government has to allocate more resources to provide health facilities to the elderly population.
- Capital formation is badly affected as the elderly population tends to spend their savings in large amounts.
- Economic growth is affected due to decreased household savings that occur as the dependency ratio is increased.
- When the child population is decreased there can be a contraction in the labour force. This may have a bad impact on the economic growth.
- The government has the ability to reduce the amount being spent on the education as the child population is decreased and then to use those resources in order to increase the quality of the education. This may create an increase in the economic growth. (03 marks).

iv) The non-formal sector consists of the individuals and households that produce goods and services with the use of a comparatively small amount of capital or one's own labour.

- According to the reports of Census and Statistics Department of Sri Lanka, 63.5 % of the total work force in Sri Lanka belongs to the non-formal sector.

- Non-formal sector consists of labour incentive, small scale production units that use a small amount of resources.
- Many in this sector are self employed people.
- Most activities are agricultural sector productions. 44% of the employees in the non-formal sector are from agricultural industry.
- Some engage in illegal business such as sales of alcohol and drugs. (4 marks).

v). Many of the employees are non-trained females.

- 53% of the total immigrant population consisted of females in 2007 and the majority of them were households.
- Many of those immigrants belong to families with low income and poor socio economic status.
- Their remittances make a massive contribution to the economy.
- More than 10% of the immigrant female population has undergone physical and mental abuses.
- Children whose mothers have migrated can have anti social behaviours and vulnerability to be abused or to become drug addicts. (3 marks).

8). Gemi Diriya is a community participation programme that has been launched in selected districts such as Badulla, Monaragala, Galle, Matara, Hambantota, Rathnapura and Polonnaruwa in Sri Lanka.

By empowering the community and encouraging their participation in village development process, sustainable development is encouraged and poverty is minimized.

Village development is planned by community controlled village development approaches with the contributions made by the community who live in the same village.

A community organization is established and then it is registered under the Company Act of Sri Lanka. (3 marks).

ii). -Export income will be decreased.

- Garment industry in Sri Lanka will have to face a serious competition in the European market.
- Risk is increased for the companies that have been functioning at a low profit margin.
- Employees of the above mentioned companies are at more risk to lose their jobs.
- Direct foreign investment may be discouraged due to the damage on Sri Lanka's international image.
- Sri Lankan exporters may have to find new markets for their goods. (4 marks).

iii). The reasons can be,

- Large amount of expenditure on electricity.
- Extremely limited opportunity that exists for village enterprises to access formal financial institutes.
- Restrictions to enter into provincial markets.
- Inefficient supply of business services in the government sector. (4 marks)

iv). The challenges are,

- Infrastructure development.
- Qualitative development in the education sector.
- Macroeconomic stability.
- Increasing investments in research and development areas.
- Pay more attention on small and medium scale industries.
- Diversification of the export sector. (4 marks).

- (iv) This shows the technical, legal or economical barriers that prevent someone from entering into a new industry or profession. It limits the competition of the industry or profession. (1 mark)

E.g. controlling the ownership of resources, intellectual rights, patent rights, cost incurred due to research and development and advertising, higher level of hidden costs. (1 mark)

- v). The production continuity of a perfectly competitive firm during the short run is decided only if the firm's revenue equals to its variable cost during the short run.

$$\text{Market Price} = \text{Minimum Average Variable Cost} \quad (2 \text{ marks})$$

SUB SECTION –B

5. i). Underground economic activities are the economic activities that are not exposed to the government tax system (purposely hidden from it) and all the illegal production of goods and services that are not recorded in national accounts. (2 marks).

ii). (a) Gross Domestic Expenditure = Personal Consumption (C) + Government Purchases (G) + Gross Domestic Fixed Capital Formation (I_f) + Change in Inventories (In).
 $= 65000 + 15000 + 18000 + 2000$
 $= 100,000/=$ (2 marks)

(b) Gross Domestic Product at market price = Gross Domestic Expenditure + Net Exports
 $= C + I_f + G + (X - M)$
 $= 100000 + (20000 - 30000)$
 $= 100000 - 10000 = 90,000/=$ (1 mark) (1 mark)

(c) Gross National Product at Market Price = GDP at market price + Net Foreign Factor Income
 $= 90000 + (-5000) = 85000/=$ (2 marks)

(d) Disposable Gross National Income = GNP at market price + Net Foreign Current Transfers
 $= 85000 + (3000 + 1000) = 89000$ (1 mark)

(The following answer is also acceptable).
 $\text{GNP} = 85000 + 3000 = 88000$

(e) Domestic Savings = Gross Domestic capital Formation + Net Exports (1 mark)
 $= 20000 + (-10000) = 10,000/=$ (1 mark)
 Or, Domestic Savings = (GDP at market price) – (Consumption expenditure of private and public sectors)
 $= 90000 - (65000 + 15000)$
 $= 10000/=$

National Savings = Domestic Savings + Net Foreign Factor Income + Net Foreign Private Transfers.
 $= 10000 + (-5000 + 3000)$
 $= 10000 + (-2000) = 8000$

Or, National Savings = (Disposable Gross National Income) – (Consumption expenditure of private and public sectors)
 $= 89000 - 80000 = 9000$
 Or, 88000 – 80000
 $= 8000/=$ (1 mark)

6. i). A country's economy is under economic recession when its real production, employment and income levels are deteriorating persistently throughout several months. (2 marks)

- ii). Aggregate Demand is the planned flow of income of an economy that has been allocated for expenses of purchases of goods and services by its households, firms and government during a specific period of time. (2 marks)

- iii). The equilibrium level of income is achieved when there is an aggregate demand that is equal to the real production (total supply). $Y=E$ (2 marks)

The level of income is expanded when the aggregate demand is greater than the value of real production. This creates an equilibrium situation. (1 mark)

- iv) Savings create a leakage in the flow of expenditure. As a result, the aggregate demand is contracted. Investment is an injection into the flow of expenditure. As a result the aggregate demand is expanded. (1 mark)

When the investment is greater than the savings ($I > S$), aggregate Demand increases. As a result, the level of real output is expanded. (1 mark)

When the investment is smaller than savings ($I < S$), aggregate Demand decreases resulting in a contraction in the level of real output. (1 mark).

When the savings equals the investments ($I = S$), the aggregate Demand remains constant. Then the level of real output reaches equilibrium. (1 mark).

- v). The equilibrium level of income in an open economy is determined on the size of the aggregate demand function of the economy.
It includes the following components.

$$E = C + I + (X - M) \quad (1 \text{ mark})$$

The aggregate demand function of an open economy is different from that of a closed economy due to the value of $X - M$. (1 mark).

At the level of equilibrium, the total withdrawals (W) equals to its total injections (J).
 $W = J$

$$S + T + M = I + G + X \quad (1 \text{ mark})$$

7. i). Market failure is referred to as the inability of the market mechanism to allocate the scarce resources for the wellbeing of the society. (2 marks)

Market failure has 2 forms.

- a). Inefficiency in resource allocation. = Production of some goods exceeding the required amount to the society and producing less than the required amounts in essential goods. (1 mark)
- b). Inequity in resource allocation. = Inefficiency in resource allocation is created due to the inequity in income distribution. (1 mark).

- ii). Externalities that emerge through the production or consumption activities create external costs or benefits. (1 mark)

When there are external costs or external benefits, a social benefit or a private benefit is created. (1 mark)

Either private benefits > social benefits or social cost > private cost when there is a negative externality due to production or consumption function. The reason is either producing goods more than the amount required by the society or the consumption exceeds the optimum level of consumption of the society. (1 mark)

Either private benefits < social benefits or social cost < private cost when there is a positive externality due to the production or consumption function. The reason is either producing goods less than the amount required by the society or the consumption being less than the optimum level of consumption of the society. (1 mark)

- iii). Consumption can be made limited. (1 mark)
- Rivalry in consumption. (1 mark)

- iv). If the consumption of a good or service creates positive externalities, the good or service being consumed is said to be a merit good. (1 mark)
Social benefit of a merit good exceeds its private benefits. While merit goods are supplied by the market mechanism, an under-consumption is created. (1 mark)

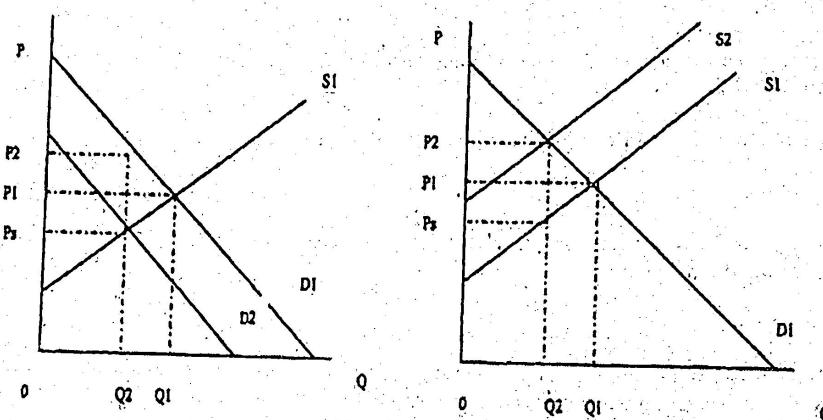
Examples: Education, health services.
If the consumption of a good or service creates negative externalities the good or service being consumed is said to be a demerit good. (1 mark)

Social benefits of a demerit good or service is less than its private benefits. While demerit goods are supplied by the market mechanism an excess consumption is created. (1 mark)

Example: consumption of cigarettes and alcohol, betting

8. i). Direct Tax = 18% -20%
 - Indirect Tax = 78% - 81% (Both as percentages of the total tax revenue.) (2 marks)
 (Direct tax and indirect tax as percentages of Gross Domestic Product are 2% to 3% and 12% to 14% respectively.
- ii). Total budget deficit as a percentage of GDP.
 - 2005=8.4%
 - 2006=8.0%
 - 2007=7.7%
 - 2008=7.7% (2 marks)
- Total budget deficit as a percentage of GDP shows a declining pattern. (1 mark)

iii).



There is no change in the amount of tax incidence created by a special sales tax and domestic excise tax as both are in the same amounts. There is no change in the expenditure made for goods by the consumer or the price of the producer. (5 marks)

- iv). - Expansion of the tax system.
 - Make the tax structure simpler.
 - Make the tax administration efficient.
 - Reformation of tax relief, concessions and tax intervals.
 - Improving the performance of government enterprises. (5 marks)

2009 – ECONOMICS - II / Part -I

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

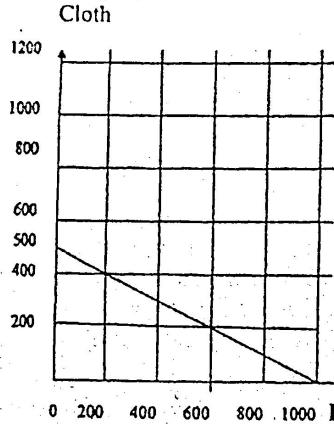
2009 – ECONOMICS - II / Part -II

1. i). As a means of exchange.
 ii). As a store of value.
 iii). As a unit of account.
 iv). As a method of deferred payment.
 - Transaction motive.
 - Precautionary motive.
 - Speculative motive. (4 marks)
- ii). Sovereign Credit Rating indicates the ability and willingness of an sovereign government to pay back any loan within the given period of time. (3 marks)
- iii). (2 marks)

- iv) - Public money deposits.
 - Issuing shares
 - Interbank call money market.
 - Foreign deposits.
 - Treasury bills/securities.
 - Formation of long-term funds.
 - Commercial papers. (3 marks)
- v). Reverse repurchasing activity of the Central Bank is the activity of selling securities to commercial banks by the CBSL with the agreement of repurchasing them on an agreed date at an agreed interest rate. (1 mark)
 Repurchasing rate is the lowest level of the interest rate of the call money market. (1 mark)
- When the CBSL changes the repurchasing rate, the lower limit of the interest rate of the call money market also changes. (1 mark)
2. i). - Reserve money. (Base money)= Operating target.
 - Broad money supply (M_{2b}) = Intermediate target
 - Price stability (Inflation rate) = final target. (4 marks)
- ii). Increasing policy interest rates during the period from 2004 to 2007. (Repurchasing rate increased up to 10.5%). (2 marks)
 Actively participating in the open market activities. (1 mark)
 Controlling the liquidity in the financial market. (1 mark)
 Limiting the reselling facilities of the CBSL. (1 mark)
- iii). Headline inflation shows the real rate of general price level that has been increased. It becomes flexible due to the price fluctuations of food and some basic necessities.
 Headline inflation can be measured by using consumer price index or GDP deflation. (2 marks)
- Core inflation shows the behaviour of the price index that is prepared disregarding certain prices in order to remove the changes in the headline inflation that takes place due to temporary reasons. Sri Lanka disregards food and fuel prices when calculating the core inflation rate. It is important to consider the core factors in the process of policy formation disregarding temporary factors that affect the general price level. (2 marks)
- iv). - Rapid increase in the food prices of the world market.
 - Increase in the fuel price.
 - Decrease in the food production at domestic level.
 - Depreciation of the exchange rate.
 - Expansion of money supply.
 - Resetting the control prices. (3 marks)
3. i).
- | Country A | | Country B | |
|------------|-------------|------------|-------------|
| Food Units | Cloth Units | Food Units | Cloth Units |
| 0 | 500 | 0 | 800 |
| 200 | 400 | 100 | 600 |
| 400 | 300 | 200 | 400 |
| 600 | 200 | 300 | 200 |
| 800 | 100 | 400 | 0 |
| 1000 | 0 | - | - |
- (4 marks)

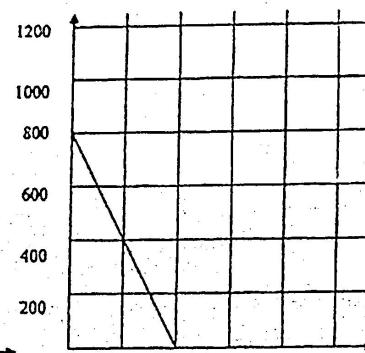
ii).

(Country A)



Cloth

(Country B)



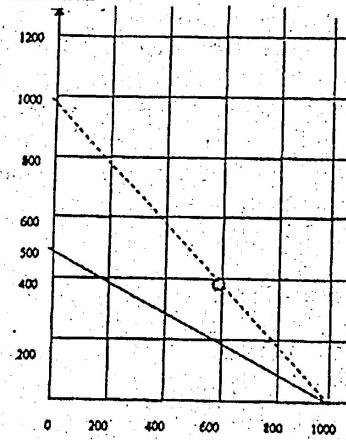
(2 marks)

- iii.
- Opportunity cost of country A producing food = $100/200 = 0.5$ cloth units
 - Opportunity cost of country B producing food = $200/100 = 2.0$ cloth units
 - Opportunity cost of country A producing cloth = $200/100 = 2.0$ food units
 - Opportunity cost of country B producing cloth = $100/200 = 0.5$ food units

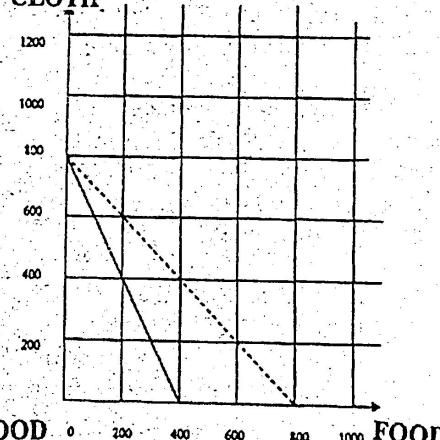
- Country A specializes in food production as they have less opportunity cost. (1 mark).
- Country B specializes in cloth production as they have less opportunity cost in producing cloth. (1 mark)

iv).

CLOTH



CLOTH



(4 marks)

(3 marks)

4.

i). Export structure.

- Decrease in agricultural export revenue - 1977=79%, 2007=20% (2005=18%, 2006=19%) (1 mark)
- Increase in the industrial export revenue - 1977=14%, 2007=76%. (2005=78%, 2006=78%) (1 mark)

Import Structure

- Decrease in the percentage of imports of consumer goods. 1977=42%, 2007=18%. (2005=19%, 2006=19%) (1 mark)
- The percentage of investment was doubled. 1977=12%, 2007=18%. (2005=21%, 2006=22%). (1 mark)

- ii). Nominal exchange rate is referred to as the expression of the value of one currency in the value of another currency. (1 mark)

Nominal exchange rate can be given as,

- Direct Reading = giving the value of a foreign currency unit in local currency units.
- Indirect Reading = giving the value of the local currency unit in a foreign currency unit. (1 mark)

Real exchange rate is the nominal exchange rate that is adjusted for the changes in the price levels of 2 countries. (2 marks)

$$\begin{aligned} \bullet & \text{ Real Exchange Rate=} \\ = & (\text{Nominal Exchange Rate}) \times \{\text{Local Price Level}/\text{foreign price level}\} \end{aligned}$$

iii). Overvalued exchange rate can be measured in 2 approaches.

- Purchasing Power Parity (PPP) Approach.
 - Current Account Balance Approach.
- According to the PPP approach exchange rate is said to be overvalued when the PPP exchange rate increases compared to the nominal exchange rate. It is also shown by the increase in the real exchange rate.
- If we find a persistent deficit in the Balance of Trade or in the Current Account under one exchange rate, the considered exchange rate is an overvalued exchange rate. In order to make the Balance of Trade and the balance in the Current Account positive it is important to reduce the value of the exchange rate. (2 marks)

iv). SAFTA=South Asia Free Trade Agreement.

- APTA= Asia Pacific Trade Agreement.
- BIMST-EC=The Bay of Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation.
- IOR-ARC= Indian Ocean Rim Association for Regional Cooperation.
- ISFTA= Indo Sri Lanka Free Trade Agreement.
- PSFTA= Pakistan Sri Lanka Free Trade Agreement. (5 marks)

SUB SECTION-B

5. i). The external resource gap is the difference between the total foreign receipts and total foreign payments. (2 marks)

- Total foreign receipts include,
 - Goods being exported.
 - Receipts of factor income.
 - Service receipts.
 - Private current transfer receipts.

(1 mark)

Total foreign payments include,

- Goods being imported.
- Private capital transfers.
- Service payments.
- Capital repayments.
- Factor income payments.
- Flow of investments.
- Private current transfer payments.
- Commercial bank payments.

(1 mark)

ii). The trends of the external resource gap.

- External resource gap as a percentage of the total foreign receipts.
 - 2005=24.3% (US \$ 2402 million)
 - 2006=28.5% (US \$ 3124 million)
 - 2007= 31.5% (US \$ 3867 million)

(2 marks)

The external resource gap in Sri Lanka is a negative value and is further being expanded. (2 marks)

iii). - Increase in the short term credit.

- Increase in the commercial credit.

(3 marks)

- Increase in the portfolio investment.

- Increase in the use of foreign assets.

Amount of the burden of debt is increased due to the higher dependency of short term commercial credit.

Pressure on the budget is increased due to the cost of debt servicing. Government's inability to settle existing debts as it has to borrow more to settle the previous (outstanding) debts.

- Increase in the risk of instability of the exchange rate due to portfolio investment and dollar bonds.
- Exchange rate not being depreciated due to external borrowings.
- Inflation being increased due to the expansion of money supply as a result of the increased external assets. (4 marks)

6. i). Economic growth shows the increase in the production capacity or the total output of the country. This is indicated by the persistent increase in the real national output of the country. (1 mark)
- Economic growth rate is the increase in the percentage of the real GDP or real GNP during a given period of time. B (1 mark)

- ii). It contributes to improve the standard of living of the general public.
- Increase the employment.
 - Makes the Balance of Payment favourable.
 - Achieves price stability.
 - Increases government revenue.
 - Supplies public and merit goods.
 - Increases savings and resources for investments. (4 marks)
- iii).
- Equity in income distribution.
 - Broadening the opportunities in employment.
 - Broadening economic and social infrastructure facilities.
 - Balanced provincial development.
 - Increasing agricultural productivity.
 - Protecting the environment. (5 marks)

iv).

Country	Human Development Index (HDI)		Country's rank according to the HDI	
	2006	2005	2006	2005
India	0.609	0.619	132	128
Pakistan	0.562	0.551	139	136
Bangladesh	0.524	0.547	147	140
Maldives	0.749	0.741	99	100
Sri Lanka	0.742	0.743	104	99

(4 marks)

7. i). - When someone's labour is not fully utilized he/she may be doing an involuntary part time work that they dislike doing. They do not get an opportunity to work on full time basis. (1 mark)
- Underemployment is also shown when the people engaged in jobs that do not reflect their competencies. E.g. graduates working as three-wheel drivers on full time basis. (1 mark)
 - Disguised unemployment is shown by employing too many employees to complete one task. (1 mark)
 - When too much labour is employed in one job, the marginal productivity of the employees is decreased. Redundancy does not make any changes in the level of production. (1 mark)
- ii). - Employees (Government and private sector)
Employers
Self employed population
Unpaid family labour (4 marks)
- iii). economically inactive population is referred to as the people who are not willing to do jobs although they are in the working age group. E.g. Housemaids, school children, disable or sick people, retired or voluntarily idle population. (1 mark)
- iv). - Favourable impact on Balance of Payment.
Favourable impact on the equity in income distribution.
Increasing national savings.
Expansion of money supply due to increased external assets.
Reduction of poverty. (Increase in the standard of living).
Small Business Development.
Expansion in real property, housing and financial services.
Maintaining the stability in the exchange rate. (5 marks)

8. i). Inability to implement economic policies with political changes.
Welfare politics.

- Instability due to civil war that existed during a long term and its higher economic cost.
- Poor fiscal policy.
- Insufficient infrastructure development.
- Corruption and politicization.
- Existence of national savings and investment rates at relatively low levels.
- Education policies not being developed favourably so as to achieve human resource development.
- Steps not taken to remove the differences in the provincial development.
- Rigidity in the labour market.

(5 marks)

ii). Ambitious growth targets include maintaining 8% of annual growth rate during the next 10 years and achieving 9%-10% growth rate after that period.

- Lack of resources that is needed to maintain sufficient level of investment in order to achieve expected growth targets. It is expected that the investment level for the next 10 years should be between 32% and 38% as a percentage of the GDP annually. Currently, national saving rate is 20%.
- Limited ability and availability of relief to acquire external resources during the economic recession that exists globally.
- Cost incurred in rehabilitating internally displaced population during the war time.
- Activating the development process in Northern and Eastern provinces.
- Government revenue not being increased sufficiently.
- Increasing debt burden.
- Political instability.

(5 marks)

iii).

- Sri Lanka's export earnings have deteriorated.
- Unemployment has increased in the export industry.
- Reduction in the revenue of export industry.
- Opening of less job opportunities for Sri Lankans in Japan, Korea, and Middle East countries.
- Decrease in the flow of foreign investment in Sri Lanka.
- Increasing external resource gap.
- Limited amount of sources to obtain foreign loans to the government.
- Government attention is focused mainly on the strengthening the local economy.

(5 marks)