Association of Accounting Technicians of Sri Lanka

Level I Examination – July 2022

Suggested Answers

(103) ECONOMICS (ECN)

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

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(103) ECONOMICS

SUGGESTED ANSWERS

(Total 40 Marks) **SECTION - A**

Suggested Answers to Question One:

Question No	Answer
1.1	(4)
1.2	(1)
1.3	(1)
1.4	(2)
1.5	(2)
1.6	(2)
1.7	(3)
1.8	(3)
1.9	(4)
1.10	(4)
1.11	Planned
1.12	Marginal Production
1.13	False
1.14	True

1.15 Characteristics of Capital as a production factor

1) Production factor created by humans
2) It is a real concept
3) Can be utilized in the production repeatedly
4) It is subjected to depreciation
5) Capital is a productive factor
6) Payment made for capital is called interest

1.16 Deficit Budget

A deficit budget is when the state expenditure exceeds state revenue.

Example: Budget Deficit = Government Revenue – Government Expenditure

= Rs.400 Million – Rs.470 Million

= (Rs.70 Million)

1.17 Reasons for imposing price controls by the government

1) Price of the good or service prevalent in the market is not affordable to the consumer.
2) To prevent unfair price hikes at a time when there is a shortage of the given item in the market.
3) To control high inflationary situation.
4) To ensure that producers receive a fair and adequate income for supplying goods or services (protect producers).

1.18 Motives for demand for money

1) Transaction Motive
2) Precautionary Motive
3) Speculative Motive

1.19 Difference between Total Product (TP) and Average Product (AP)

Total Product (TP) - When increasing quantity of variable factor is added to the fixed factor, the amount of output produced over a given period is referred to as the total product.

Average Product (AP) - The total output per unit of variable input is refereed as the average product of the variable factor. It can be derived by dividing the total product from the number of units of the variable input used.

$$\textbf{Average Product} = \frac{\textbf{Total Output Produced}}{\textbf{Units of Variable Input}}$$

1.20 Items in the profile of Human Development

1) Income
2) Education
3) Health Conditions
4) Political Freedom
5) Healthy Social Relations
6) Empowerment
7) Equality

(02 marks each, Total 40 marks)

End of Section A

Suggested Answers to Question Two:

Chapter 01 - Economic Concepts and Systems Related to Business Environment

(a)

Opportunity Cost refers to the value of the next best alternative forgone of an economic activity as a selection of an opportunity due to scarcity of resources and alternative uses of resources. Opportunity cost is a real concept which may or may not include monetary value in the decision making. It is the main cost which is considered in the decision making in economics.

Example 1: Amal decided to start a business by investing Rs. 100,000/- out of his personal savings which were withdrawn from one of his fixed deposits. The opportunity cost of Amal starting the business would be the interest on the invested capital he could have earned.

Example 2: If a Student has decided to settle his tuition fee of Rs. 2,500/- he has, and if the next best alternative he had to forgo was purchasing a Movie Ticket, Then the opportunity cost of this student settling his tuition fee would be purchasing a Movie Ticket.

(03 marks)

(b)

<u>What and how much should be produced:</u>

The private sector tends to produce the goods that command the higher prices and provide higher profits. The government sector produces goods with the motive of increasing social welfare. Government influences prices, through taxes and subsidies and affects the operation of price mechanism directly and indirectly.

<u>How to produce:</u>

The private sector uses more profitable and least cost methods of production. The government's choice of production techniques are based on the maximizing social welfare and equity of the society.

<u>For whom to produce:</u>

Mixed economy is determined this problem by the purchasing power of the public and it is influenced by the government. (Under mixed economic system State/Government influences the purchasing power of people through taxes, subsidies and transfer payments. Also The purchasing power of the public depends on the ownership of human and material resources. Examples of how government interferes in altering the purchasing power of people can be mentioned as follows;

Eg.- Imposing of progressive taxes on income and wealth, granting subsidies to low income groups, introduction of social security schemes.

(04 marks)

Chapter 03 - Behavior of Production Process and Different Market Structures

(c) Characteristics of a Monopoly Market

1) Barriers to Entry
2) Unique Product / Product with no close substitutes
3) Only a single firm engages in the production
4) Availability of imperfect / incomplete information and it is not possible to obtain the information at free cost
5) Price Maker
6) Profit maximization
7) Economic of scale
8) Price discrimination

(03 marks)
(Total 10 marks)

Suggested Answers to Question Three:

Chapter 02- Demand, Supply, Equilibrium and Ways of Government Intervention

(a)

(i) Qd = 1600 – 5P
Qs = -800 + 3P

Qd	**=**	**Qs ; at the Equilibrium**
1600 – 5p	=	-800 + 3P
1600 + 800	=	5P + 3P
2400	=	8P
300	**=**	**P**

Substituted for the Qd Equation

Qd = 1,600 – 5P
= 1,600 – (5×300)
= 1,600 – 1500
= **100 (Units)**

Or

Substituted for the Qs Equation

Qs = -800 + 3P
= -800 + (3×300)
= -800 + 900
= **100 (Units)**

Equilibrium Price = Rs.300
Equilibrium Quantity = 100 Units

(04 marks)

(ii) **Consumer Surplus** $= \dfrac{\left[\text{Maximum Price at which the Commodity is sold in the Market} - \text{Equilibrium Price}\right]}{2} \times \text{Equilibrium Quantity}$

$= \dfrac{(320 - 300) \times 100}{2}$

= <u>**Rs.1,000**</u>

Workings *- Finding Maximum price at which the commodity is sold in the Market*

Qd = 1,600 – 5P ⟶ Substituting "0" to "Qd"

0 = 1,600 – 5P

5P = 1,600

<u>P = 320</u>

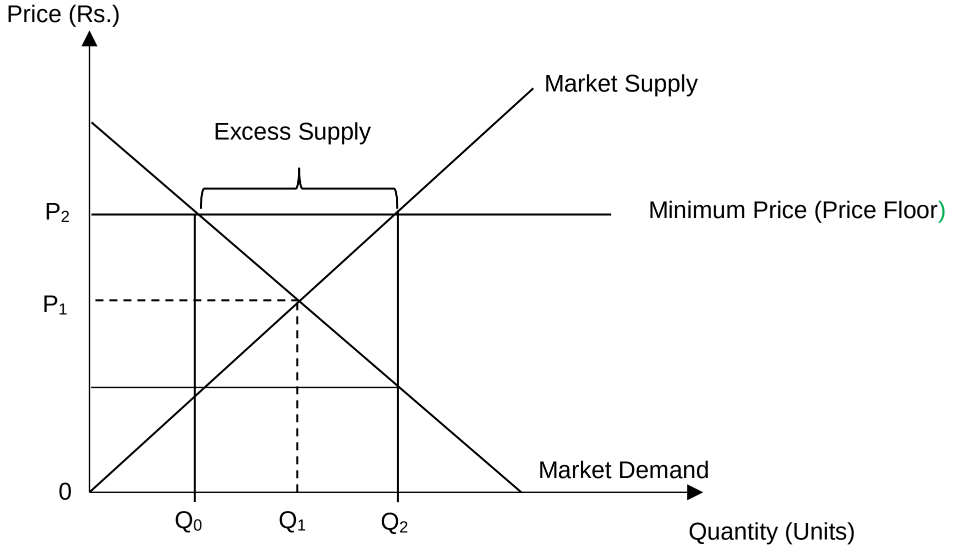
(02 marks)

(b)

The objective of imposing a minimum price is to protect producers by fixing a reasonable price in a way of safeguarding producers. When a minimum price is imposed, An excess supply will be created in the market. This would in turn create disequilibrium in the market by creating inefficiencies of allocation / distribution of scarce resources of the economy. Therefore, it is important to take necessary measures to eliminate the excess supply in the market. For instance government can;

- Purchase the excess supply and store for future use
- Advise and support the producers to export the excess supply
- Encourage producers to producers to produce substitute products from the excess supply etc.

Further there can arise opportunities for intermediaries to purchase the product (Especially from small and medium scale producers) at a lower price and resell it at the floor price.



(04 marks)
(Total 10 Marks)

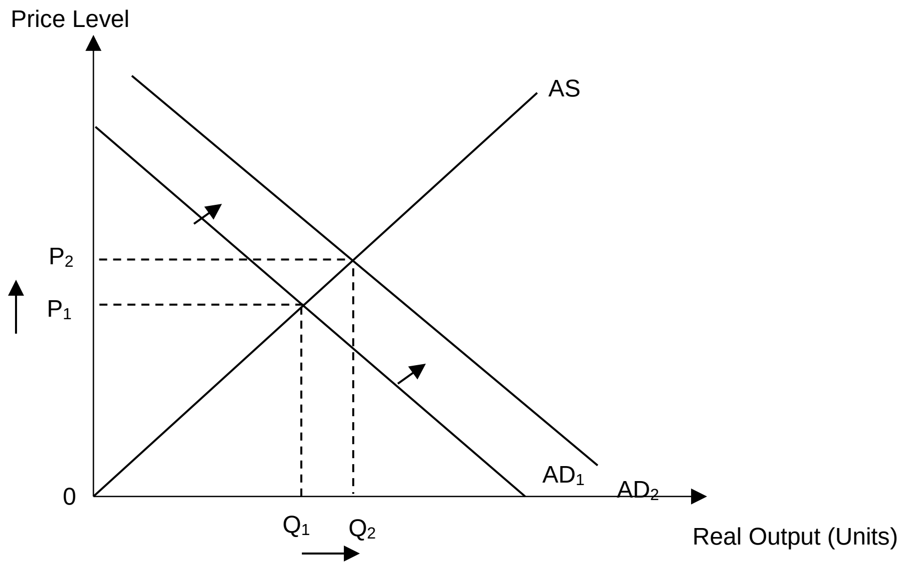
Suggested Answers to Question Four:

Chapter 05 - Financial System, Money and General Price Level

(a) The Difference between Demand pull inflation and Cost Push inflation

Demand pull inflation refers to the increase in general price level of the economy due to increase in demand for goods and services over the supply of goods and services in a given period. Demand pull inflation is caused by increase in money supply, increase in private and government expenditure, increase in export income of an economy etc.

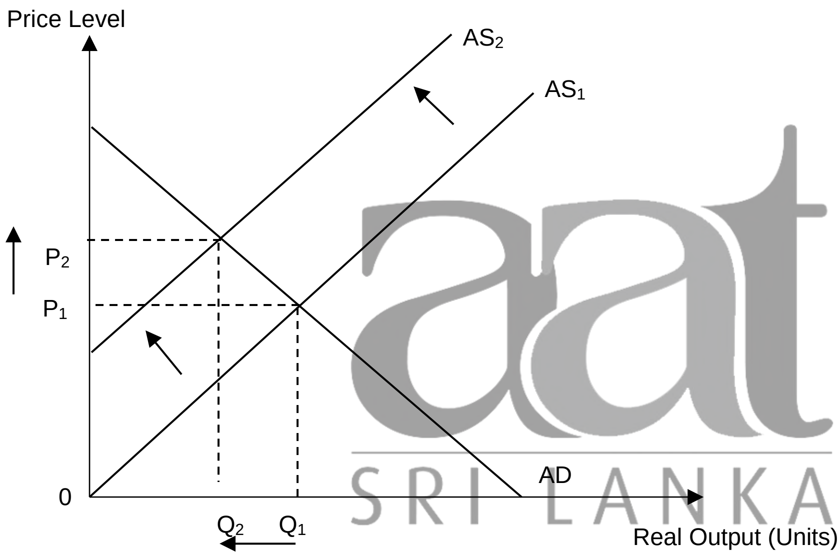
Demand pull inflation occurs when total demand for goods and services exceeds total supply. This type of inflation happens when there has been excessive growth in aggregate demand and there is an inflationary gap.



Cost push inflation occurs when firms increase prices to maintain or protect profit margin after experiencing a rise in their cost of production and it is usually the result of increase in the cost of production. Cost push inflation originates from the supply side, and it is an increase in price level of the economy due to increase in cost of production and decrease in aggregate supply in the given period.

Some of the reasons for cost push inflation are,

- Increase in wage rate of the economy
- Increase in interest rate of the economy
- Increase in raw material prices and other input prices
- Increase in import prices



(04 marks)

(b) Qualitative controls of the monetary policy of the Central Bank of Sri Lanka

1) Setting a maximum maturity period for loans
2) Setting preferential rates of interest
3) Setting Limits for loan guarantees
4) Setting limits for investments and loans
5) Setting limits for letter of credit and cash balance
6) Indirect Control (Moral Suasion)
7) Control of loan flow from commercial banks by getting their cooperation instead of direct control

(02 marks)

(b) How monetary policy can influence to overcome / reduce the current economic crisis of Sri Lanka

Monetary policy is a process which the Central Bank controls the supply of money, availability of money and cost of money or the rate of interest in order to attain a set of macro-economic objectives towards the growth and stability of the economy. It includes the actions taken by central bank or monetary authorities of an economy to control money supply and interest rate of the economy.

A stable monetary policy is important to keep macroeconomic stability and confidence in the local currency. Economists view monetary policy as the first – line of defense against economic slowdown/ crisis.

Changing monetary policy has important effects on aggregate demand and thus on both output and prices. There are number of ways in which policy actions get transmitted to the real economy.

Central Bank of Sri Lanka can influence to overcome the current economic crisis of Sri Lanka through monetary policy, by using financial policy instruments. Through quantitative and qualitative instruments, CBSL can take the measures to overcome the current economic crisis.

- ***Quantitative Control Instruments***

    1) Bank rate policy

Bank Rate is the minimum rate at which the Central Bank of a country provides loans to the commercial banks of the country. Through the changes in bank rate, the Central Bank can influence the creation of credit by the commercial banks.

For instance, when the Central Bank raises the bank rate the cost of borrowing by the commercial banks from the Central Bank would rise. This would discourage the commercial banks to borrow from the Central Bank. Further, when the bank rate is raised, the commercial bank also raise their lending rates. When the lending rates i.e. Interest rates charged by the commercial banks are higher. Businessmen, industrialists and potential investors would feel discouraged to borrow more from commercial banks. ^This would tend to contract credit and hence would result in the reduction of Money Supply in the economy. So with this, the main economic problem that SL is facing now “inflation” can be reduced.

2) Open market operations

Open Market Operations are another important instrument of credit control. The term OMO means the purchase and sale of securities by the Central Bank to absorb or inject the excess liquidity in the open market.

The sale of securities by the Central Bank leads to contraction of credit. When the Central bank sells the securities in the open market, it receives money in the form of a cheque of one of the commercial banks. It reduces money supply.

3) Reserve rate policy

Reserve Rate is the ratio of commercial bank deposits that are maintained as a cash reserve in the form of cash in hand or in the Central Bank. An increase of the reserve ratio will reduce the money supply. This will also help to reduce the inflation prevailing in the country.

- ***Qualitative Control Instruments***

1) Setting a maximum maturity period for loans
2) Setting preferential rates of interest
3) Setting Limits for loan guarantees
4) Setting limits for investments and loans
5) Setting limits for letter of credit and cash balance
6) Indirect Control
7) Control of loan flow from commercial banks by getting their cooperation instead of direct control

(04 marks)
(Total 10 marks)

Suggested Answers to Question Five:

Chapter 06 - International Trade and Foreign Exchange Market

(a)

	Opportunity Cost, Rice (kg)	**Opportunity Cost, Wheat (kg)**
X	3/6 = 0.5	6/3 = 2
Y	4/2 = 2	2/4 = 0.5

Country – X has the comparative advantage in the production of Rice whereas Country – Y has the comparative advantage in the production of Wheat.

(04 marks)

(b) Reasons for recent devaluation of the Sri Lankan Rupee against US Dollar

1) **Artificially holding the exchange rate for a long time.**

Exchange rate was fixed without considering demand and supply of exchange rate and suddenly it was floated. It resulted to increase in dollar rate.

2) **Gap between import expenditure and export income.**

Sri Lanka import expenditure exceeds its export income. It creates deficit balance of trade account.

3) Maintaining interest rates lower than inflation, compelling people to consume instead of saving.

4) Heavy dependency on foreign loans for financing balance of payment gap.

5) Foreign loans which were taken for projects have been used for settling trade account deficit and foreign reserves were used to pay interest on loan.

6) With COVID -19, foreign remittances from workers have been reduced. It resulted a decrease in the country's forex supply.

7) Increase in oil and gas prices in global economy due to shortage of raw material. It resulted to devaluate the rupee against US $.

8) Due to COVID-19 pandemic, tourists arrival have been dropped drastically and as a result, the country loss the foreign income that could have been earned and as a result, the SL rupee has devalued against USD.

9) Low export growth: When export income decreases foreign currency supply reduces and currency is devalued.

10) Withdrawn of foreign investment from the country and low investments inflows to the county.

11) Because of the political and economic reasons, a lot of foreign investors have left the country and as a result, our currency has been devalued.

(04 marks)

(c) Advantages of International trade

1) Acceleration of economic growth.
2) Growth in international economic cooperation.
3) Ability to find a market to sell the surplus production.
4) Ability to buy the goods which cannot be produced domestically.
5) Inflow of foreign loans, foreign grants and foreign investments to the country.
6) Greater variety of goods available for consumption. People will be able to consume a combination of goods located outside the Production Possibility Curve
7) Efficient allocation and better utilization of resources since countries tend to produce goods in which they have comparative advantage
8) Promotes efficiency in production as countries will try to adopt better method of production to keep cost down in order to remain competitive.
9) More employment could be generated in the areas of transportation, banking, insurance etc, as the market for the countries' goods widen through trade. This situation will lead to an increase in income generation.
10) Transfer of technology and knowledge
11) Non – economic advantages in relation to areas like political, social and cultural to be gained by fostering trade in international organizations.

(02 marks)
(Total 10 marks)

End of Section B

Suggested Answers to Question Six:

Chapter 04 - National Accounting and Role of the Government

(A)

(a)

(i) Gross Value Added (GVA) at basic price

	(Rs. Million)
Compensation of Employees	1,000
Gross Operating Surplus	1,400
Mixed Income	1,200
Other taxes less subsidies on production	750
Gross Value Added (GVA) at basic price	**4,350**

(05 marks)

(ii) Gross Domestic Product (GDP) at market Price

	(Rs. Million)
Gross Value Added (GVA) at basic price	4,350
Net taxes on production (GDP) at market price	500
Gross Domestic product (GDP) at market price	**4,850**

(02 marks)

(iii) Gross National Income (GNI) at market price

		(Rs. Million)
Gross Domestic Product (GDP) at market price		4,850
Net Foreign Primary Income		
Foreign Primary Income Receipts	1,200	
Foreign Primary Income Payments	(1,500)	(300)
Gross National Income (GNI) at market price		**4,550**

(03 marks)

(b) Productive Economic activities which are not included in Gross Domestic Product

1) Studying and leisure
2) Natural resources obtained at free cost (Land, Water, Air)
3) Unpaid domestic services
4) Natural resources that grow without human effort (forests)
5) Change in the value of resources due to changes in price or natural growth

(03 marks)

(B) The difference between fair distribution of income and full employment as Macro – Economic Objectives

Fair distribution of income

Ensuring fair levels of income distribution among its population, a country is able to achieve equality. Income and wealth should be distributed in a way to ensure that every citizen of a country should have the ability to fulfill his/her wants and needs.

Full Employment

An economy achieves full employment level when all the resources in the economy are utilized in the full of maximum efficiency. When aiming at achieving full employment level it is necessary to minimize labour unemployment by increasing employment opportunities.

(04 marks)

Chapter 07 - Economic Growth Development and New Trends in Economy

(C) Determinants of Economic Growth

1) Factor Endowment
   - Physical Capital
   - Human Capital
   - Natural Capital
   - Social Capital
2) Productivity
   - Technology
   - Innovation
   - Investments on Research and Developments
3) Economic Stability
4) Political Stability
5) Good Governance
6) Incentives
7) Visionary leadership

(03 marks)
(Total 20 marks)

End of Section C

Notice:

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These should be understood as Suggested Answers to question set at AAT Examinations and should not be construed as the "Only" answers, or, for that matter even as "Model Answers". The fundamental objective of this publication is to add completeness to its series of study texts, designs especially for the benefit of those students who are engaged in self-studies. These are intended to assist them with the exploration of the relevant subject matter and further enhance their understanding as well as stay relevant in the art of answering questions at examination level.