

G.C.E. (A.L.) Support Seminar - 2015
Economics - Paper I
Answer Guide

Question No	Answer	Question No	Answer
(1)	3	(26)	3
(2)	2	(27)	3
(3)	4	(28)	3
(4)	2	(29)	1
(5)	5	(30)	3
(6)	5	(31)	3
(7)	4	(32)	5
(8)	2	(33)	5
(9)	4	(34)	3
(10)	5	(35)	4
(11)	1	(36)	5
(12)	4	(37)	4
(13)	5	(38)	5
(14)	5	(39)	2
(15)	1	(40)	4
(16)	2	(41)	1
(17)	1	(42)	2
(18)	2	(43)	1
(19)	3	(44)	3
(20)	5	(45)	4
(21)	3	(46)	2
(22)	2	(47)	1
(23)	4	(48)	3
(24)	2	(49)	1
(25)	2	(50)	2

Economics - Paper II Answer Guide

1. (i) The resource which limited supply or scare resources can be defined as economic resources. Due to scarcity of economic resources, there is opportunity cost for them. **(Mark 01)**

Ex: Arable land, Laborers ,machinery, instruments, entrepreneurship abilities **(Mark 01)**

Non economic resources can be defined as the resources which have unlimited supply at zero price level when uses the opportunity cost of non-economic resources becomes zero.

(Mark 01)

Ex : Sunlight uses for drying clothes
South west monsoon rain

(Mark 01)

(ii)

Nature of the Economic system	Nature of the ownership
1. Capitalist Economic System	Property is owned by private sector
2. Socialist Economic System	Property is owned by government sector
3. Mixed Economic System	Both government and private sector owned the resources.
4. Traditional Economic System	Resources is commonly used by the people in the society.

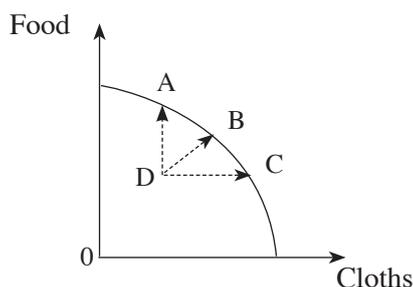
- (iii) Price mechanism performs three roles in a market economy.

1. Supply signals
2. Supply incentives
3. Rationing

The role of price mechanism for allocating resources among alternative uses can be said that to solve the problem of what and how many / much to produce, how to produce.

The question of what and how many / much to produce solves the allocation of resources to produce relatively more profitable goods **(Marks 04)**

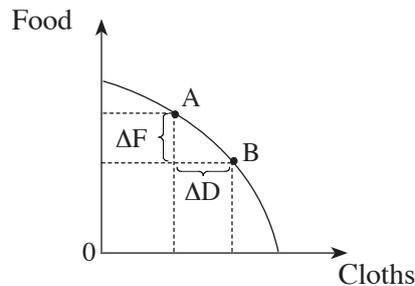
- (iv) If there is an under utilization of resources in an economy those resources can be utilized for production process without opportunity cost



Resources is under utilized at point D. Therefore if only increased the production of food it can move to point A without opportunity cost, only increased the production of cloth it can move to point C and if, both increase food and cloth production it can move to point B.

(Marks 02)

If an economy is at point of economic efficiency the economy produce at a commodity mix on the production possibility curve, it is unable to change the resource utilization without opportunity cost.



When economy produce at point A and increase the utilization of resource to produce cloth then food production is to be scarified. If produce at point B and increase the resource utilization for food production, cloth production has to be scarified. So if change the resource utilization when producing on production possibility curve opportunity cost is generated.

(Marks 02)

- (v) This statement is wrong. To fulfill economic efficiency both production efficiency and resource allocation efficiency should be achieved.

When production efficiency is occurred the output should be maximum under the given amount of resource or minimize the required amount of resource for producing the given level of output.

To obtain production efficiency it should be satisfied two conditions

1. Full employment
2. Full production

The meaning of the allocation of resources efficiency is the allocation of resources for the highly preferred goods by the people. So the production is determined under the social preference.

To fulfill allocative efficiency of resources, price of all units of commodity should be equal to its marginal cost ($P = MC$).

(Marks 04)

2. (i) • Individual demand is the expected quantities of demand for a good by a consumer at alternative prices.
• Market demand is the total of demand of all the individual buyers for commodity at the market.

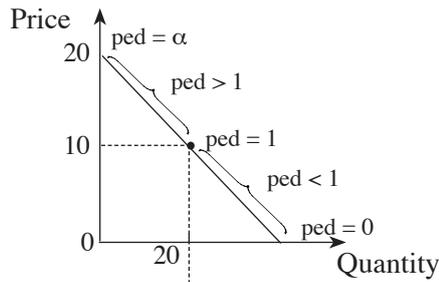
(Marks 02)

- (ii) Quantity demanded become negative function of its price due to two reasons.

- ★ Substitution effect
- ★ Income effect

(Marks 02)

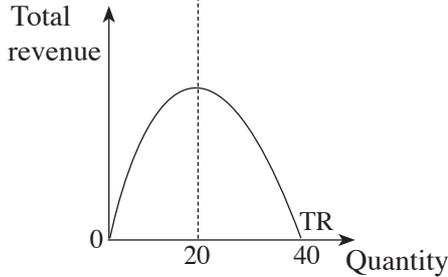
(iii)



$$\text{at Rs:0 } ped = \frac{\Delta Q}{\Delta P} \times \frac{P}{Q} = \frac{20}{10} \times \frac{0}{40} = 0$$

$$\text{at Rs:10 } ped = \frac{\Delta Q}{\Delta P} \times \frac{P}{Q} = \frac{20}{10} \times \frac{10}{20} = 1$$

$$\text{at Rs:20 } ped = \frac{\Delta Q}{\Delta P} \times \frac{P}{Q} = \frac{20}{10} \times \frac{20}{0} = \alpha$$



For graphs **(Marks 02)**

- The price decrease on the elastic portion of demand curve affects to increase firm revenue.
 - Firm revenue becomes maximum on the unitary elastic point of the demand curve.
 - The Price decrease on the inelastic portion of the demand curve affects to decrease firm revenue.
- (Marks 02)**

(iv) Elasticity of supply of several goods can become less than 1 or greater than 1. It can be occurred due to following reasons.

- The ability of collecting stocks for the particular good.
- The ability to bilise of factors to the production process for the particular good.
- The time has been spent after changing the price of particular good.
- The amount of capacity utilized in the production process for the particular good.

(Marks 04)

(v) (a) $Q_d = a - bP$ $Q_s = a + bP$
 $b = \frac{\Delta Q_d}{\Delta P} = \frac{20}{4} = 5$ $b = \frac{\Delta Q_s}{\Delta P} = \frac{20}{4} = 5$

$Q_d = a - 5P$ $Q_s = a + 5P$

$100 = a - 5(20)$ $60 = a + 5(20)$

$100 = a - 100$ $60 = a + 100$

$200 = a$ $60 - 100 = a$

$Q_d = 200 - 5P$ $-40 = a$

(Mark 01) $Q_s = -40 + 5P$

(Mark 01)

(b) $Q_d = Q_s$ $Q_d = 200 - 5P$ $Q_s = -40 + 5P$
 $200 - 5P = -40 + 5P$ $Q_d = 200 - 5(24)$ $Q_s = -40 + 5(24)$
 $200 + 40 = 5P + 5P$ $Q_d = 200 - 120$ $Q_s = -40 + 120$
 $240 = 10P$ $Q_d = 80$ **Or** $Q_s = 80$
 $24 = P$ **(Mark 01)**

(Mark 01)

(c) Supply equation after subsidy.

$$\begin{aligned} Q_{s_1} &= -40 + 5(P + 10) & OR & & Q_d &= Q_s \\ Q_{s_1} &= -40 + 5P + 50 & & & 200 - 5P_b &= -40 + 5P_s \\ Q_{s_1} &= 10 + 5P & & & 200 - 5P_b &= -40 + 5(P_b + 10) \end{aligned}$$

$$\begin{aligned} \text{Price after Subsidy} & & 200 - 5P_b &= -40 + 5P_b + 50 \\ Q_d &= Q_{s_1} & 200 - 5P_b &= 10 + 5P_b \\ 200 - 5P &= 10 + 5P & 190 &= 10P_b \\ 190 &= 10P & 19 &= P_b \\ 19 &= P & & \end{aligned}$$

$$\begin{aligned} \text{Equilibrium quantity after subsidy} & \\ Q_d &= 200 - 5P \\ Q_d &= 200 - 5(19) \\ Q_d &= 200 - 95 \\ Q_d &= 105 \end{aligned}$$

(Marks 02)

$$\text{Government Expenditure for subsidy.} = 10 \times 105 = 1050$$

Change in consumer expenditure

$$\text{Consumer expenditure before subsidy} = 24 \times 80 = 1920$$

$$\text{Consumer expenditure after subsidy} = 19 \times 105 = 1995$$

$$\text{Consumer expenditure (1995 - 1920)} = \text{Increased by Rs. 75}$$

(Marks 02)

3. (i) Total revenue - (Explicit cost) = Accounting profit (Marks 02)

Total revenue - Total opportunity cost (explicit cost + implicit cost) = economic profit (Marks 02)

Normal profit is the minimum earning expects by entrepreneur for his/her role of entrepreneurship. (Marks 02)

- Not concern about implicit cost when calculating accounting profit.
- Due to concern of implicit cost in economic profit accounting profit is greater than economic profit.
- Normal profit included in implicit cost. when $TR > TC$ receives economic profit.

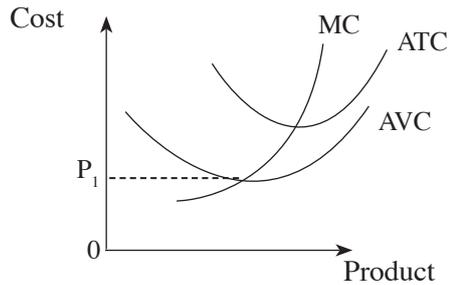
(ii) When produce by keeping constant of fixed inputs and changing variable inputs in a firm at short run, marginal and average product of variable input is falling after a certain point, that is explained by law of diminishing returns. When marginal product increase then marginal cost decrease at short run. Law of returns to scale explains the production process related to long run percentage of out increased. It explains that the output increased less than the percentage of input increased. So long run average cost increases.

At the long run when all the inputs change (volume) related to production process, the behavior of output is explained by the law of returns to scale. The out put increases less than the percentage increased of all inputs is explained by the law of returns to scale. When there is decreasing returns to scale long run overage cost increases.

(Marks 04)

- (iii) When a firm expands its production at long run it gets advantages due to reducing unit cost and that is explained by economies of scale. Economies of scale generated due to,
- (a) Technological Economies
 - (b) Marketing Economies
 - (c) Managerial Economies
 - (d) Financial Economies
 - (e) Economies related to bearing risk
- (Marks 04)**

- (iv) • Minimum supply price is the price exists when average variable cost becomes minimum.
 P_1 is example in the graph



(Marks 04)

- (v) • There are infinite numbers of buyers and sellers.
• Free entry and exit.
• Produce homogeneous goods.

(Marks 02)

4. (i) (a) Gross Domestic Product (at m.p) = Domestic Savings + Total Consumption

$$\begin{aligned} &= S_D + (C + G) \\ &= 400 + 800 \\ &= \text{Rs. } 1200 \text{ m} \end{aligned}$$

(Marks 02)

(b) Net Domestic Income = Rent + Wage + Interest + Corporate Profit

$$\begin{aligned} &= 250 + 400 + 150 + 150 \\ &= \text{Rs. } 950 \text{ m} \end{aligned}$$

(Marks 02)

(c) Capital Depreciation = Gross Domestic Product - Net Domestic Product

$$\begin{aligned} &= 1200 - (950 + 150) \\ &= \text{Rs. } 100 \text{ m} \end{aligned}$$

(Marks 02)

- (ii) • Not Compulsorily equal
• But there are some situations where can be equal
- (a) A country there is no foreign trade
 - (b) Both export earnings equal to import expenditure
- When value of export and import are not equal there is disparity between gross domestic expenditure and gross domestic Product. When $X > M$ gross domestic expenditure $<$ Gross domestic Product. When $X < M$ gross domestic expenditure $>$ gross domestic Product.
- (Marks 04)**

(iii) When it is unable to get data or not clearly compute the value, some productive deals is missed from the national accounting. It is a major incident in developing countries.

- ★ Activities of housemaids
- ★ Subsistence economic activities
- ★ Informal economic activities
- ★ Hidden economic activities
- ★ Non Reported effective economic activities

(Marks 04)

- (iv)
- Measuring of economic growth
 - Economic performance can be measured
 - Investigating the economic structure and its change
 - Identifying Resources and resource utilization
 - For international Comparison
 - Examine functional income distribution
 - Economic Policy making

(Marks 04)

- (v)
- Rent
 - Wage
 - Interest
 - Corporate Profit
 - Depreciation
 - Net indirect Tax (If it is at market price)



(Marks 02)

5. (i) Disposable income in a simple economy is used for two purposes. Those are Consumption and saving. If a part of disposable income is used for saving then the value of marginal propensity to consume is less than 1.

(Marks 02)

- (ii)
- 1) Increasing private Consumption expenditure
 - 2) Increasing investment expenditure
 - 3) Increasing government expenditure
 - 4) Increasing net export
 - 5) Independent tax decreasing
 - 6) Decreasing autonomous import

(Marks 04)

(iii) (a) $c = a + b Y_d$

$$b = \frac{\Delta C}{\Delta Y_d} = \frac{1500}{2000} = 0.75$$

$$C = a + 0.75 Y_d$$

$$1250 = a + 0.75 \times 1000$$

$$1250 = a + 750$$

$$500 = a$$

$$C = 500 + 0.75 Y_d$$

(Marks 02)

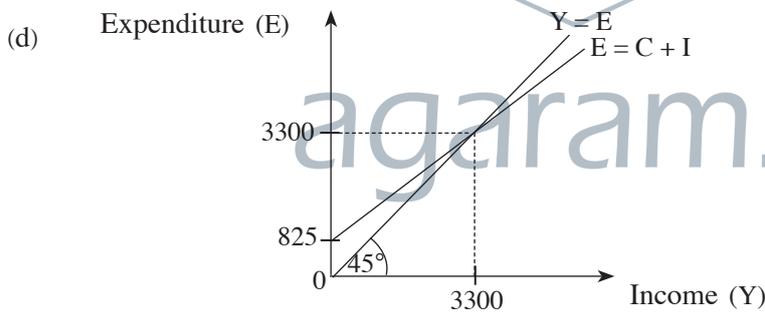
(b) $Y = C + I + G$
 $Y = 500 + 0.75 Y_d + 300 + 100$
 $Y = 900 + 0.75 (Y - T)$
 $Y = 900 + 0.75 (Y - 100)$
 $Y = 900 + 0.75 Y - 75$
 $Y = 825 + 0.75 Y$
 $0.25 Y = 825$
 $Y = 3300$

(Marks 02)

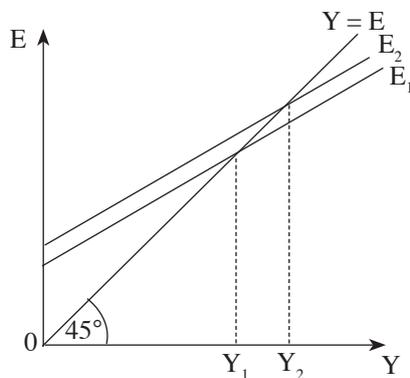
Savings at equilibrium Income

(c) $W = J$ $S = -500 + 0.25 Y_d$
 $S + T = I + G$ $S = -500 + 0.25 (Y - 100)$
 $300 + 100 = 300 + 100$ $S = -500 + 0.25 Y - 25$
 $400 = 400$ $S = -525 + 0.25 Y$
 $S = -525 + 0.25 (3300)$
 $S = 300$

(Marks 02)



(iv) Due to insufficient aggregate demand to maintain the full employment level of output in an economy it reaches to the equilibrium at the level of unemployment.



(02 Marks for Picture)

Full employment level is at Y_2 . To maintain that level the E_2 level of aggregate demand should be existed. If real level of aggregate demand exist at point E_1 economy reaches to equilibrium at Y_1 level of output. There is unemployment between $Y_2 - Y_1$.

(02 Marks for explanation)
 [See page 9]

6. (i) ★ Transaction motive
 ★ Precautionary motive
 ★ Speculative motive

(Marks 03)

(ii) Money supply = Monetary base × Money multiplier

Factors determine the monetary base

- ★ Amount of net foreign assets owned by central bank.
- ★ Amount of net credit to the government by the central bank.
- ★ Amount of credit to the commercial banks by the central bank
- ★ Other net assets of central Bank

Factors determine the money multiplier

- ★ Amount of excess reserve in the Commercial Banking system
- ★ Statutory reserve ratio
- ★ Ratio between currency and demand deposits held by the public

(Marks 04)

(iii) (a) Excess reserve = Actual reserve - Statutory reserve

$$= 250 - (2000 \times \frac{10}{100})$$

$$= 250 - 200$$

$$= 50$$

Amount of making ability of new loans is Rs:50 million.

(Marks 02)

(b)

Liabilities (Rs. M.)		Assets (Rs. M.)	
Deposits	2050	Deposits	250
		Loans	1800
	<u>2050</u>		<u>2050</u>

(Marks 02)

(iv) **Objectives of Central Bank** **Roles of Central bank**

● **Price and economic stability**

- ★ Conducting the monetary policy
- ★ Conducting the exchange rate policy
- ★ Managing Official foreign reserve
- ★ Issuing currency

● **Stability of monetary System**

- ★ Monitoring and regulating of financial institutions
- ★ Act as the lender of last resort
- ★ Provide clearing facilities

(Marks 04)

- (v) (a) ● Trend of Continuously increasing the general level of price in a prolonged in a country is called inflation
● Trend of continuously decrease the general level of price in a prolonged in a country is called deflation. **(Marks 02)**

- (b) ● Colombo Consumer price index
● Wholesale price index
● Implicit price index (GDP deflator) **(Marks 03)**

7. (i) When implementing public finance policy as a demand management policy of a government after the full employment level of output, it is unable to increase the output hence price level is going to be increased and no economic growth. When implementing demand management policies it has to be faced for this limitation. Supply side policies can be implemented as alternative.

Ex : Privatization, Deregulation

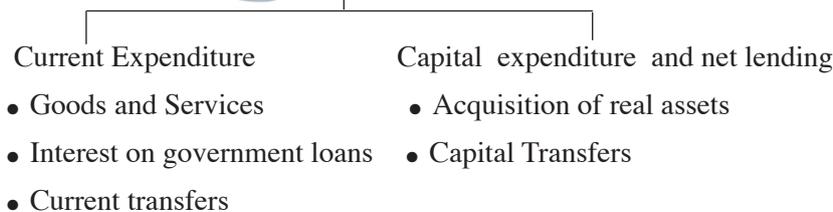
Labour market and Capital market reforms, Tax reforms **(Marks 04)**

- (ii) The tax base means that the factors subjected to the tax
Ex: If income is the base for tax, tax categorized as income tax
If foreign trade is the base for tax, tax is categorized as export tax and import tax.
If sale is the base for tax, tax is categorized as preferential trade tax. **(Marks 04)**

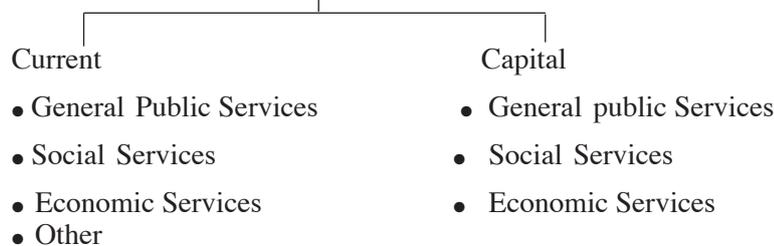
- (iii) Government Expenditure can be categorized under two Criterias.

- ★ Economic Classification
- ★ Functional Classification

Economic Classification



Functional Classification



(Marks 04)

(iv)(a) Overall Balance = Government revenue and grants – Government Total Expenditure
= 12 000 – 15 000
= – 3 000 **(Marks 02)**

(b) Net Cash Deficit = Overall Budget deficit – Amortisation payments
= – 3 000 – 1 000
= – 2 000 (Marks 02)

(v) Change of Government loan amount

	Rs. Billion	Government loans as % of GDP	
2011	5133	78.5	
2012	6000	79.2	
2013	6793	78.3	(Marks 02)

- Government loans has been increased absolutely

Impacts of Increasing government loans

- Increasing the government debt Services
- Cause to become current account deficit in the government budget
- Foreign value of rupee become appreciate due to inflow of foreign loans
- Balance of payment problems is created when pay loans in long term
- Money supply can be expanded due to getting loans
- Crowding out effect can be made when government gets loans from local market sources.
- Cause to increase the rate of interest (Marks 02)

8. (i) (a) Absolute advantage for Australia for both goods (Marks 02)

(b) Milk powder - Australia
Canned Fish - New Zealand (Marks 02)

(c)

New Zealand	Australia
Packet of Milk powder 1 = Canned Fish 2	Packet of Milk powder 1 = Canned Fish 0.5
Canned Fish 1 = Milk powder 0.5	Canned Fish 1 = Packet of Milk powder 2

 (Marks 02)

- (d) • New Zealand should export 1 canned fish and import packet of milk in between 0.5 and 2.
• Australia should export 1 packet of milk and import canned fish in between 0.5 and 2. (Marks 02)

(ii) Nominal Protection rate is the measurement of protection received by local producer through imposing tax on imported good. Import a good with domestic product due to increasing the price of export good the protection receives by the domestic Product.

$$\text{Nominal Protection Rate} = \frac{\text{Price of local product after tax}}{\text{Price of imported product after tax}} \times 100$$

Effective rate is the added value of local product after tax (V_1) as a percentage of added value of local product before tax (V_0)

$$\text{Rate of Effective Protection} = \left(\frac{V_1 - V_0}{V_0} \right) \times 100$$

(Marks 04)

(iii) (a)	Financial account Debit (million)	150	
	Trade good account Credit (million)		150
(b)	Service account Debit (million)	20	
	Financial account Credit (million)		20
(c)	Financial account Debit (million)	50	
	Primary Income account Credit (million)		50
(d)	Financial account Debit (million)	30	
	Secondary Income account Credit (million)		30
(e)	Direct investment (Financial account) Debit (million)	500	
	Financial account Credit (million)		500

(Marks 05)

- (iv) Rate of exchange of domestic currency in terms of foreign currency is determined by the monetary authorities and keeping it at a constant level for a certain period is called fixed exchange rate. Gold standard is an example for a perfect fixed exchange rate

Floating exchange rate can be defined as when rate of exchange of a currency ratio is determined by the demand and supply of the foreign currency unit at the market. It is continuously vulnerable to change the rate of exchange according to the market forces.

(Marks 03)

9. (i) Accumulation of Resource

- Exploring new resources
- Inflow of foreign investment
- Capital formation
- Immigration of foreign skilled labour

Changing the productivity of resources

- Development of Technology
- Development of Management
- Development of Competencies
- Division of labour

Macroeconomic Stability

Political Stability

Good Governance

Growth of entrepreneurs

(Marks 02)

(ii) ● **Development**

Process of Producing the standard of living of the people in a country can be concerned as development. It is a multidimensional process. That is the changing Process of Standard of living of the people in to the positive direction in every dimension of economic, social, Cultural and political spheres.

● **Human Development**

The widening of selective opportunities of People's capabilities. Provide the opportunities to get physical and human needs for live longer of every people in the society with happiness. It is a process of widening opportunities of choosing in order to expand personal roles and abilities.

According to the Amartya Sen the process of expansion of persons entitlements and capabilities can be defined as human development.

● **Sustainable Development**

Satisfy the needs of present society without harming to the needs of future generation. There are three dimensions.

- ★ Economic development
- ★ Social development
- ★ Environmental Protection



(Marks 06)

(iii) **Decreasing crude birth rate**

- ★ Decreasing Child fertility
- ★ Family planning and birth control
- ★ Increase women employment
- ★ Increasing of age of marriage

Net migration rate becoming minus value

- ★ Foreign migration for education
- ★ Foreign migration for employment
- ★ Migrate to foreign countries on kinship relations

Economic impact

- ★ Population ageing
- ★ Decrease child population
- ★ Increasing dependency rate
- ★ Demographic dividends
- ★ Decrease of government expenditure on welfare

(Marks 04)

(iv) There are two dimensions of income poverty

Absolute poverty

Non-receiving of enough income to achieve basic needs of a person or group of persons can be defined as absolute poverty. Absolute poverty is important when deciding economic policies.

It is measured by

- 1) Percentage of poor households.
- 2) Poverty head count index

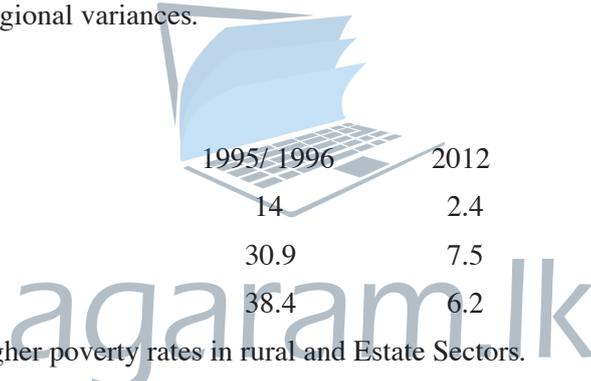
Relative Poverty

If a group of people in a society are at a lower level to achieve economic and social needs with compared to other group of people can be defined as relative poverty. It is measured by keeping the people who gets 50% from mean income as percentage of total population. The percentage of population who is under the 40% income limit which the families who gets low income in a country. (Marks 04)

(v) National Poverty incidence has been decreased

- 1990 26.1
 - 1995/ 1996 28.8
 - 2002 22.7
 - 2006 / 2007 15.2
 - 2009 / 2010 8.9
 - 2012 6.7
- Whole poverty incidence has been decreased in Sri Lanka.
 - But there are regional variances.

Sector wise



	1995/ 1996	2012
Urban	14	2.4
Rural	30.9	7.5
Estate	38.4	6.2

- Still there is higher poverty rates in rural and Estate Sectors.

(Marks 04)

10. (i) Socio economic effects

The population ageing effects on various segments of the economy and society. The main segments are labour supply, Capital market, Production, saving and investment, public financing, government debt, Income, Employment and health sectors.

Solutions and Policy actions:

- ★ Increase the number of years of working and implementation of pension reforms
- ★ Improving the field of health
- ★ Social Security benefits
- ★ Reforms in labour market
- ★ Introducing technology to grow efficiency of labour

(Marks 05)

(ii) Opportunities

- ★ Exist potentials in agriculture sector (Agriculture)
- ★ Exist potentials in aquaculture (Aquaculture)
- ★ Exist potentials in livestock field (Animal Husbandry)
- ★ There are investment opportunities in Naval and Air fields. (5 Hubs)

Barriers

- ★ weaknesses related to infrastructure facilities
- ★ Electricity (Electricity breakdown)
- ★ Limited opportunities for financial facilities and high cost
- ★ Macroeconomic instability
- ★ Regulations of using labour (Rigidities in labour market)
- ★ High tax burden
- ★ Violation of good governance
- ★ Transportation problems in rural areas

(Marks 05)

- (iii) Poverty has been decreased up to 6.7. Growth activities implemented by last decade has effected to reduce whole poverty in Sri Lanka. Those are the policy measures taken by the government.

Macroeconomic Policies

- Controlling inflation
- Allow for open economy on selected basis

Sectoral Policies

- Promotion of suitable economic fields for poors
Ex : (Agriculture, Development of human capital, empowering Women)

Regional Policies

- Developing of rural areas
- Income redistribution
- Land distribution
- Providing loan facilities
- Providing transfers
- Providing information technology facilities for rural areas

(Marks 05)

- (iv) Following trends can be seen when consider about migration of Sri Lankan people to foreign countries.

- Women migration is very high
- When concern the direction of migration, majority migrate to midleast countries.
- Migrate to provide labour for house holds activities
- Labour migration impact of economy may be positive or negative

Positive Effects

- Increase foreign earnings
- Receive solution for balance of payment problems
- Solution for problem of unemployment
- Solution to poverty
- Encourage for investment when migrated people return to country
- Bring new technology to Sri Lanka

Negative Effects

- Insecurity in the household
- Loss of parental protection for children.
- Not receiving formal security to migrated people in foreign countries.
- Reduce domestic labour force and shortage of skilled labour
- Brain drain

(Marks 05)

* * *



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