



Department of Examinations - Sri Lanka

G.C.E. (A/L) Examination - 2021 (2022)

21 - Economics

Marking Scheme

External Environment Impacts on Sri Lanka - 2020

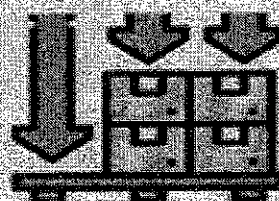


Merchandise
Exports – Fell by

15.6%

Merchandise
Imports – Fell by

19.5%

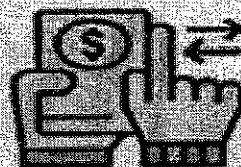


Tourist Arrivals
– Fell by

73.5%

Remittances –
Increased by

5.5%



Source: Central Bank of Sri Lanka (2020)

This has been prepared for the use of marking examiners. Some changes would be made according to the views presented at the Chief Examiners' meeting

Amendments to be included

CONTENTS

	Page
	To From
Economics - 1	03 - 10
Marking Scheme for Economics - I	11 - 11
Marking Scheme for Economics - II	12 - 36
Notes	37

(21) Economics

STRUCTURE OF QUESTION PAPERS

Paper I - 02 Hours

There are 50 multiple – choice and each question has 5 optional answers. All questions are compulsory. Each correct answer is given 01 marks and the total marks will be 50

Paper II - 03 Hours

This paper consists of two sub – sections.

Sub- section A – 5 structured type question

Sub- section B – 5 structured type question

Answer five questions only, selecting minimum of two questions from each sub – section. Each question has 20 marks and the total marks will be 100.

Calculation of the final mark - Paper I 50

Paper II 100

$$\text{Final mark} - 50 + \left(\frac{100}{2} \right) = \underline{100}$$

இலங்கைப் பரீட்சைத் திணைக்களம் Department of Examinations, Sri Lanka		
අධ්‍යයන පොදු සහතික පත්‍ර (උසස් පෙළ) විභාගය, 2021(2022) கல்விப் பொதுத் தராதரப் பத்திர (உயர் தர)ப் பரீட்சை, 2021(2022) General Certificate of Education (Adv. Level) Examination, 2021(2022)		
ආර්ථික විද්‍යාව பொருளியல் Economics	I I I	21 E I පැය දෙකයි இரண்டு மணித்தியாலம் Two hours

Instructions:

- * Answer all the questions.
- * Write your **Index Number** in the space provided in the answer sheet.
- * Instructions are given on the back of the answer sheet. Follow them carefully.
- * In each of the questions from 1 to 50, pick one of the alternatives from (1), (2), (3), (4), (5) which is **correct or most appropriate** and mark your response on the answer sheet with a cross (x) in accordance with the instructions given on the back of the answer sheet.

1. A more complete short definition of economics would be that economics is the study of
 - (1) how employment opportunities in society could be created to make its citizens better off.
 - (2) how countries trade goods and services in a global market place.
 - (3) how goods and services are produced without damaging the environment.
 - (4) how unlimited resources are allocated among limited wants.
 - (5) how scarce resources are allocated to satisfy unlimited wants.
2. Production possibilities frontiers are linear because
 - (1) resources are being used fully and efficiently.
 - (2) of the Law of increasing opportunity costs.
 - (3) of inefficiencies in the economy.
 - (4) of constant opportunity costs.
 - (5) of non-homogeneous resources.
3. Which of the following is a fundamental feature of the free market economy?
 - (1) Strict government control of production
 - (2) More imports than exports
 - (3) Public ownership of resources
 - (4) Private property
 - (5) Prices and wages set by the government
4. What is **not** a benefit of division of labour?
 - (1) Increased flexibility of the workforce.
 - (2) Reduced total cost of producing goods and services.
 - (3) Increased productivity.
 - (4) Increased ability to introduce innovations.
 - (5) Increased income equality.
5. When the price of rice increases it is expected that the
 - (1) quantity demanded of rice increases.
 - (2) quantity supplied of rice decreases.
 - (3) quantity demanded of rice decreases.
 - (4) demand for rice decreases.
 - (5) supply of rice increases.

6. Suppose that textile is a key input in the production of wearing apparel. If the price of textile falls while all other variables are held constant, it is expected that the
- (1) demand for textile to rise.
 - (2) supply of wearing apparel to rise.
 - (3) supply of wearing apparel to fall.
 - (4) demand for wearing apparel to rise.
 - (5) demand for wearing apparel to fall.

7. The supply function of good X is given by the equation $Q_s = 8P$, where P is the price of the good and Q_s is the quantity supplied. According to this equation, the price elasticity of supply of good X is
- (1) 1.0
 - (2) -1.0
 - (3) 8.0
 - (4) -8.0
 - (5) 0.1

8. Suppose the market for avocado faces two simultaneous events. When there is a severe drought affecting the supply of avocado, findings of a research reported that avocado contains medicinal properties which may help avoiding cancer. How will these two events affect the equilibrium price and equilibrium quantity in the avocado market?

	Equilibrium Price	Equilibrium Quantity
(1)	Increases	Decreases
(2)	Increases	Increases
(3)	Decreases	Decreases
(4)	Increases	Indeterminate
(5)	Decreases	Indeterminate

9. Suppose the market for good X is currently in equilibrium. Which of the following events would not cause decrease in both equilibrium price and equilibrium quantity of good X?

- (1) An increase in the price of good Y which is a complement for good X.
- (2) A decrease in the price of good Y which is a substitute for good X.
- (3) A decrease in consumer income and good X is a normal good.
- (4) An increase in consumer income and good X is an inferior good.
- (5) An increase in the number of buyers in the market for good X.

10. The table below shows the daily market supply and demand for green leaves in a small town.

Price per kilogram (Rs.)	Quantity demanded per day (kg.)	Quantity supplied per day (kg.)
60	220	310
55	240	300
50	260	290
45	280	280
40	300	270

Suppose supply of green leaves falls by 60 kg at all prices due to increase in transport costs. What is the new equilibrium price of green leaves?

- (1) Rs. 60
- (2) Rs. 55
- (3) Rs. 50
- (4) Rs. 45
- (5) Rs. 40

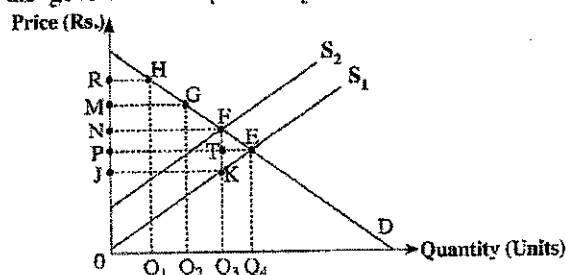
11. Suppose a rise in the price of a good from Rs. 40 to Rs. 50 causes a decrease in quantity demanded from 1600 to 1400 units. In this range of the demand curve, the price elasticity of demand is

- (1) - 6.0
- (2) - 3.0
- (3) - 0.7
- (4) - 0.6
- (5) - 0.3

12. The cost to the government of introducing a guaranteed minimum price for a commodity above the free market equilibrium price will be greatest if,

- (1) demand and supply are both price elastic.
- (2) demand and supply are both price inelastic.
- (3) demand is price elastic and supply is price inelastic.
- (4) demand is price inelastic and supply is price elastic.
- (5) demand and supply both have unitary price elasticity.

13. The diagram below displays a market for good X. The competitive market equilibrium is at point E. Suppose the government imposes a per unit tax on the production of good X.



Which areas of the diagram show the revenue collected by the government and the deadweight loss due to tax?

	Tax Revenue	Deadweight Loss
(1)	P N F T	F T E
(2)	O N F Q ₃	K T E
(3)	J P T K	K F E
(4)	J N F K	K F E
(5)	J N F K	K T E

14. Suppose in a competitive market, the equilibrium price of a certain product is Rs. 50 per unit. Now the government intervenes into this market and a minimum price is set at Rs. 60 per unit. If the demand function of an individual buyer in the market is $Q_d = 240 - 3P$, what would be the impact of minimum price on consumer surplus?

- (1) increases by Rs. 600 (2) decreases by Rs. 600
 (3) increases by Rs. 750 (4) decreases by Rs. 750
 (5) decreases by Rs. 1350

15. The table below shows total cost for a firm at different levels of output in the short run.

Output level	Total cost (Rs.)	Output Level	Total Cost (Rs.)
0	100	4	160
1	120	5	190
2	130	6	238
3	138	7	296

According to above information, What is the average variable cost of producing 6 units of output?

- (1) Rs. 23 (2) Rs. 28 (3) Rs. 35 (4) Rs. 36 (5) Rs. 48

16. In the short run when a perfectly competitive firm operates at its profit maximising level of output of 1000 units, market price is Rs. 120 per unit, variable cost per unit is Rs. 100 per unit and fixed cost is Rs. 40 per unit. Other things being equal, the short run behaviour of the firm should be to

- (1) reduce output in order to reduce costs.
 (2) increase the price over Rs. 140 per unit.
 (3) continue to produce as it operates in the short run.
 (4) increase output level in order to reduce average fixed cost.
 (5) shut down immediately as average total cost is above the market price.

17. Which of the following is true for a perfectly competitive firm in the short run?

- (1) The firm always earns positive economic profit.
 (2) The firm always earns a normal profit.
 (3) The firm shuts down when the price falls below the average total cost.
 (4) The firm maximises profit by producing at the point where the price equals marginal revenue.
 (5) The firm may earn negative, positive or normal profit.

18. Which of the following industries in Sri Lanka is most likely to be monopolistically competitive?

- (1) Tire manufacturing (2) Television broadcasting (3) Soft drinks
 (4) Newspaper (5) Beauty salons

19. Economic recession is characterised by all of the following **except**
- (1) decline in investment and employment.
 - (2) increase in the price of inputs due to increased demand for inputs.
 - (3) investors confidence is shaken.
 - (4) demand for goods and services decline.
 - (5) existence of excess production capacity of industries.
20. A paddy farmer sells paddy to a rice miller for Rs. 10 000 and the rice miller sells rice to a rice flour miller for Rs. 12 000 and the flour miller sells flour to a noodles manufacturer for Rs. 15 000 and the noodles manufacturer sells noodles to consumers for Rs. 20 000. In this production process, what is the total value added by rice miller and noodles manufacturer?
- (1) Rs. 10 000 (2) Rs. 7 000 (3) Rs. 5 000 (4) Rs. 3 000 (5) Rs. 2 000
21. Which of the following items is **not** included when estimating Gross National Income by income method?
- (1) Compensation of employees (2) Mixed income
 - (3) Consumption of fixed capital (4) Other taxes less subsidies on production
 - (5) Employee contribution to Employee's Provident Fund
22. In 2019, Sri Lanka's Gross Domestic Product at current market price was US Dollars
- (1) 79 billion. (2) 80 billion. (3) 83 billion. (4) 84 billion. (5) 88 billion.
23. Which of the following is the correct relationship between multipliers?
- (1) Investment multiplier > Tax multiplier = Balanced budget multiplier.
 - (2) Tax multiplier = Investment multiplier < Balanced budget multiplier.
 - (3) Tax multiplier > Investment multiplier > Balanced budget multiplier.
 - (4) Tax multiplier > Investment multiplier = Balanced budget multiplier.
 - (5) Investment multiplier > Tax multiplier > Balanced budget multiplier.
24. Suppose in a closed economy without government sector, aggregate saving function is $S = -100 + 0.25 Y$ and investment (I) is Rs. 800 million. What is the equilibrium level of national income in this economy?
- (1) Rs. 1 200 million. (2) Rs. 2 800 million. (3) Rs. 3 200 million.
 - (4) Rs. 3 600 million. (5) Rs. 3 900 million.
25. Which of the following is an example of a leakage from the circular flow of income?
- (1) Investment (2) Transfers (3) Imports
 - (4) Government purchases (5) Exports
26. Assume that in a given time period, the general price level of a country tripled. In the same period, the income level of a certain household rose from Rs. 40 000 to Rs. 80 000. What happened to this household's nominal and real income?
- | | Nominal Income | Real Income |
|-----|----------------|-------------|
| (1) | Increased | Decreased |
| (2) | Decreased | Decreased |
| (3) | Increased | Increased |
| (4) | Decreased | Increased |
| (5) | Increased | Unchanged |
27. Households demand more money balances as an asset when
- (1) general price level increases.
 - (2) nominal National income falls.
 - (3) nominal National income increases.
 - (4) nominal interest rate falls.
 - (5) bond prices fall.

28. Which of the following is most liquid?

- (1) Fixed deposits (2) Government securities (3) Demand deposits
(4) Real estate (5) Company shares

29. Suppose a customer makes a deposit of Rs. 400 million with a commercial bank which keeps Rs. 80 million as statutory reserve for this deposit. All else constant, how much the bank have in excess reserves? What is the size of the deposit multiplier?

	Excess Reserves (Rs. million)	Deposit Multiplier
(1)	400	0.02
(2)	400	0.2
(3)	320	20.0
(4)	320	5.0
(5)	320	0.2

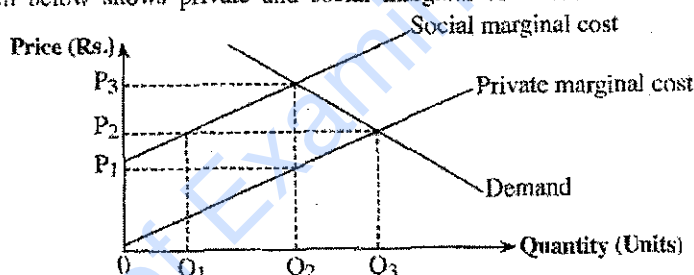
30. Which of the following will result an increase in the money supply?

- (1) An increase in the Standing Deposit Facility Rate (SDFR)
(2) Selling bonds to the commercial banks by the Central Bank
(3) An increase in the discount rate
(4) A decrease in the external assets of the Central Bank
(5) A decrease in the statutory reserve ratio

31. The main characteristics of common resources are,

- (1) rivalry in consumption and non-excludability.
(2) non-rivalry in consumption and excludability.
(3) non-rivalry in consumption and non-excludability.
(4) ability to regulate and excludability.
(5) rivalry in consumption and excludability.

32. The diagram below shows private and social marginal cost curves and the market demand curve.



If this market is an unregulated free market, then

- (1) the level of output is socially optimum, but price is too low.
(2) the level of output is less than socially optimum level, but price is too low.
(3) the allocation of resources will be efficient.
(4) too much output will be produced.
(5) too little output will be produced.

33. The Primary Balance of the budget is the difference between

- (1) total expenditure and total recurrent expenditure of the government.
(2) budget deficit and debt service payments of the government.
(3) total revenue and total expenditure including interest payment on its debt.
(4) total revenue including grants and total capital expenditure including interest payments on its debt.
(5) total revenue including grants and total recurrent expenditure including interest payments on its debt.

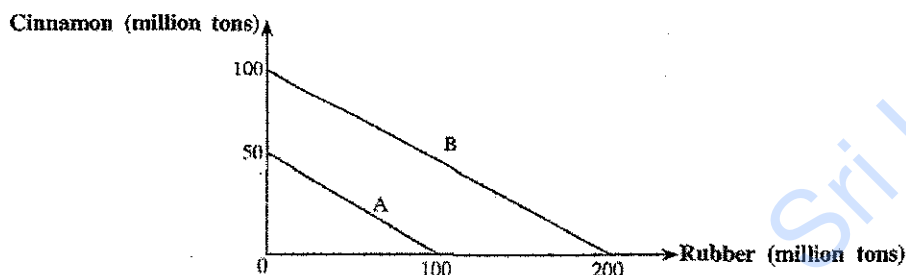
34. The share of total outstanding domestic and foreign debt of the central government of Sri Lanka as a percentage of Gross Domestic Product in 2019 were respectively

- (1) 44.1% and 42.6% (2) 48.2% and 40.3% (3) 35.4% and 46.6%
(4) 42.7% and 38.4% (5) 42.2% and 30.0%

35. Which of the following considered a supply-side policy?

- (1) A reduction in the government budget deficit
- (2) Granting investment tax credits for businesses to encourage investment
- (3) The imposition of tariff on imported goods
- (4) Transfer of privately owned businesses to the government sector
- (5) An increase in government spending that would lead to increased aggregate demand

36. The diagram shows production possibility curves for two countries, A and B. Country A can produce 100 million tons of rubber or 50 million tons of cinnamon. Country B can produce 200 million tons of rubber or 100 million tons of cinnamon.



According to the theory of comparative advantage,

- (1) both countries can benefit by specialisation.
- (2) country B has a higher opportunity cost than country A in producing cinnamon.
- (3) country A has a higher opportunity cost than country B in producing cinnamon.
- (4) country B exports cinnamon to country A.
- (5) trade between country A and country B cannot take place.

37. Which of the following options correctly indicates the composition of imports in Sri Lanka at present?

	Consumer goods	Intermediate goods	Investment goods
(1)	20%	57%	23%
(2)	22%	60%	18%
(3)	24%	45%	31%
(4)	25%	51%	24%
(5)	28%	49%	23%

38. The table below shows the record of export price index and import price index of a country for a period of six years.

Year	Export price index	Import price index	Year	Export price index	Import price index
1	100	100	4	116	120
2	105	108	5	129	129
3	112	110	6	150	130

In which year were the terms of trade most favourable relative to year 1?

- (1) Year 2
- (2) Year 3
- (3) Year 4
- (4) Year 5
- (5) Year 6

39. Suppose a Sri Lankan investor purchased shares in a manufacturing company in Japan for \$ 10 million. How would this transaction be recorded in the Balance of Payments in Sri Lanka according to the principle of double entry system?

	Debit	Credit
(1)	Capital account	Primary income account
(2)	Other investment account	Portfolio investment account
(3)	Portfolio investment account	Other investment account
(4)	Financial derivative account	Direct investment account
(5)	Capital account	Portfolio investment account

40. The table below shows some selected data from a Balance of Payments statement of a country.

Item	Rs. Billion
Exports (goods)	600
Imports (goods)	800
Services (net)	30
Primary income (net)	-80
Secondary income (net)	150
Capital account (net)	60

According to the information in the table, which statement is correct for the Balances of Payments situation of this country?

- (1) There is a deficit of Rs. 180 billion on the trade balance.
 - (2) There is a surplus of Rs. 140 billion on the capital and financial account.
 - (3) There is a surplus of Rs. 100 billion on the current account.
 - (4) There is a deficit of Rs. 40 billion on the financial account.
 - (5) There is a surplus of Rs. 40 billion on the financial account.
41. According to the Marshall-Lerner condition, in which of the following situations the current account of the Balance of Payments will improve following a depreciation of exchange rate?
- (1) Price elasticity of imports = - 0.6 and price elasticity of exports = - 0.4
 - (2) Price elasticity of imports = - 0.8 and price elasticity of exports = - 0.7
 - (3) Price elasticity of imports = - 0.3 and price elasticity of exports = - 0.5
 - (4) Price elasticity of imports = - 0.4 and price elasticity of exports = - 0.2
 - (5) Price elasticity of imports = - 0.6 and price elasticity of exports = - 0.3
42. In a floating exchange rate system,
- (1) the Balance of Payments will always be in surplus.
 - (2) the Balance of Payments will always be in deficit.
 - (3) completely insulate the economy from external forces.
 - (4) the exchange rate should adjust to equate demand and supply of foreign exchange.
 - (5) the government intervenes to influence the determination of the exchange rate.
43. Which of the following would likely contribute to achieve faster rates of economic growth?
- (1) More rapid consumption of natural resources.
 - (2) Protective trade policies.
 - (3) Higher government funding for research and development.
 - (4) Increase in consumer subsidies.
 - (5) Higher taxes on households and firms.
44. The key social and economic dimensions captured in the Human Development Index are
- (1) long and healthy life, education and decent standard of living.
 - (2) longevity, adult literacy and per capita income.
 - (3) computer literacy, rate of employment, and level of poverty.
 - (4) calorie consumption, income inequality and human resource development.
 - (5) gender equality, computer literacy and food security.
45. The table below shows the income shares by quintiles of income receivers in a country in 2010 and 2020.

Year	1 st Quintile	2 nd Quintile	3 rd Quintile	4 th Quintile	5 th Quintile
2010	5%	10%	15%	25%	45%
2020	4%	8%	12%	26%	50%

According to the table it may be concluded that over the ten-year period

- (1) there has been an improvement in resource allocation in the country.
- (2) the distribution of income became more unequal.
- (3) the distribution of wealth became more unequal.
- (4) the economic condition of low income receivers has improved.
- (5) there has been a decline in the productivity of low income receivers.

46. Some of the typewriter operators without computer skills lost their jobs as computers started to dominate the field of word processing. This is an example of which of the following unemployment category?

- (1) Frictional unemployment
- (2) Disguised unemployment
- (3) Structural unemployment
- (4) Seasonal unemployment
- (5) Cyclical unemployment

47. Sustainable development covers three main spheres, namely

- (1) environment, economy and society.
- (2) environment, economy and equity.
- (3) environment, hunger and society.
- (4) environment, peace and poverty.
- (5) environment, partnership and society.

48. The table below summarises the labour market situation in a hypothetical economy.

Year	Working age population (million)	Employed population (million)	Unemployed population (million)
2018	50	24	6
2020	60	32	8

Based on this information which of the following is an accurate statement?

- (1) The rate of unemployment has increased from 2018 to 2020.
- (2) The rate of unemployment has decreased from 2018 to 2020.
- (3) The labour force participation rate has increased from 60% in 2018 to 67% in 2020.
- (4) The labour force participation rate has decreased from 2018 to 2020.
- (5) Although the population has grown the labour force has remained constant from 2018 to 2020.

49. According to the country economic classification, in which year was Sri Lanka assigned a upper middle income country status by the World Bank?

- (1) 2016
- (2) 2017
- (3) 2018
- (4) 2019
- (5) 2020

50. The three most heavily loss-making state-owned enterprises in Sri Lanka at present are

- (1) Ceylon Electricity Board, National Lotteries Board and State Engineering Corporation.
- (2) Sri Lankan Airlines Ltd., Ceylon Electricity Board and Ceylon Petroleum Corporation.
- (3) Sri Lankan Airlines Ltd., Sri Lanka Ports Authority and Lanka Sathosa Ltd.
- (4) Ceylon Electricity Board, Sri Lanka Insurance Corporation and State Pharmaceuticals Corporation.
- (5) Sri Lanka Transport Board, National Savings Bank and Lanka Sugar Company Ltd.

* * *

ශ්‍රී ලංකා විභාග දෙපාර්තමේන්තුව
இலங்கைப் பரீட்சைத் திணைக்களம்

අ.පො.ස. (උ.පෙළ) විභාගය/ க.பொ.த. (உயர் தர)ப்பரீட்சை - 2021 (2022)

විෂය අංකය
பாட இலக்கம்

21

විෂය
பாடம்

ECONOMICS

ලකුණු දීමේ පටිපාටිය/புள்ளி வழங்கும் திட்டம்
I පත්‍රය/பத்திரம் I

ප්‍රශ්න අංකය வினா இல.	පිළිතුරු අංකය விடை இல.	ප්‍රශ්න අංකය வினா இல.	පිළිතුරු අංකය விடை இல.	ප්‍රශ්න අංකය வினா இல.	පිළිතුරු අංකය விடை இல.	ප්‍රශ්න අංකය வினா இல.	පිළිතුරු අංකය விடை இல.	ප්‍රශ්න අංකය வினா இல.	පිළිතුරු අංකය விடை இல.
01.	5	11.	4	21.	5	31.	1	41.	2
02.	4	12.	1	22.	4	32.	4	42.	4
03.	4	13.	4	23.	5	33.	2	43.	3
04.	5	14.	4	24.	4	34.	1	44.	1
05.	3	15.	1	25.	3	35.	2	45.	2
06.	2	16.	3	26.	1	36.	5	46.	3
07.	1	17.	5	27.	4	37.	1	47.	1
08.	4	18.	5	28.	3	38.	5	48.	3
09.	5	19.	2	29.	4	39.	3	49.	4
10.	2	20.	2	30.	5	40.	5	50.	2

❖ විශේෂ උපදෙස්/ விசேட அறிவுறுத்தல் :

එක් පිළිතුරකට/ ஒரு சரியான விடைக்கு ලකුණු 01
இலகුණ/மொத்தப் புள்ளிகள் 01 × 50 = 50

මෙම මාලිමාව අයිතිවාසිකම් / முழுப் பதிப்புரிமையுடையது / All Rights Reserved

<p>දෙවන පොළ සහතික පත්‍ර (උසස් පෙළ) විභාගය, 2021(2022) கல்விப் பொதுத் தராதரப் பத்திர (உயர் தர)ப் பரீட்சை, 2021(2022) General Certificate of Education (Adv. Level) Examination, 2021(2022)</p>	
<p>ආර්ථික විද්‍යාව II பொருளியல் II Economics II</p>	<p>21 E II</p>
<p>පැය තුනයි மூன்று மணித்தியாலம் Three hours</p>	<p>අමතර කියවීමේ කාලය - මිනිත්තු 10 යි மேலதிக வாசிப்பு நேரம் - 10 நிமிடங்கள் Additional Reading Time - 10 minutes</p>
<p>Use additional reading time to go through the question paper, select the questions you will answer and decide which of them you will prioritise.</p>	

Instructions:

- * Answer five questions only, selecting minimum of two questions from Sub section 'A' and two questions from Sub section 'B'.
- * Graph papers will be provided.

Sub section 'A'

(Select minimum of two questions from this section.)

01
<p>1. (i) Outline two economic characteristics of 'land' as a factor of production. (04 marks)</p> <p>(ii) "A 500 acre land in the outskirts of a city is considered by the environmental authority to be preserved in its natural state as this area is home for many endangered species. The urban development authority has planned to build an urban housing complex on the land." Identify and explain the elements of scarcity, choice and opportunity cost which are involved in this case. (2 × 3 = 06 marks)</p> <p>(iii) Why is production possibilities curve negatively sloped and bowed out? (04 marks)</p> <p>(iv) (a) Define mixed economy. (02 marks)</p> <p>(b) State four examples of economic activities which support the view that 'Sri Lanka is a mixed economy'. (04 marks)</p>

1. (i) - Land is fixed in supply. An increase in price being offered for land will not bring about an increased supply.
- Land has no cost of production to society.
- Land is gift provided by Nature.
- Land is a non-specific factor: Land can be used for various purposes.
- Land is immovable: It cannot be transported from one place to another.
- Land is a primary factor: It does not become part of the product and does not disappear within the production process.

(01 mark each for any four characteristics; Total marks 04)

- (ii) - The 500-acre plot located in an urban area has a demand for alternative uses. The environmental authority wants it to preservation in its natural state and the urban development authority wants this site for housing construction. Therefore, this plot of land is a scarce resource. **(02 marks)**
- Because of scarcity a choice must be made between the alternative uses of land. It is not possible to use the land for both activities at the same time. Therefore choice has to be made between the two uses - preservation in its natural state or site for houses. **(02 marks)**
- Choice involves sacrifice of one thing to get something else. It is the opportunity cost of the activity chosen. The opportunity cost of preserving the land in its natural state is the forgone value of the land as a housing development. The opportunity cost of using the land as a housing development is the forgone value of preserving the land. **(02 marks)**
(Total marks 06)
- (iii) - The negative slope of the PPC reflects opportunity cost of production. In order to have more of one good, some of the other must be foregone. **(01 mark)**
- It is bowed out because of the existence of increasing opportunity cost. Increase production of it. When you increase the production of one good by equal quantities, the quantity of other good that you have to sacrifice (opportunity cost) will increase gradually. **(01 mark)**
- There are three causes for increasing opportunity cost:
- (a) Resources are not homogeneous
 - (b) Techniques used to produce different goods and services are different and
 - (c) A resource that is more appropriate to produce a particular good or Service is not so appropriate to produce another good or service.
- (01 mark each for any two reasons ; 02 marks)**
(Total marks 04)
- (iv) (a) - Mixed economy is an economic system which combines both elements of market economy and command economy to solve fundamental economic problems. It blends aspects of both capitalism and socialism. **(01 mark)**
- A mixed economy is an economy in which both the public and private sectors play an important role. A mixed economic system protects

private property and allows a level of economic freedom in the use of capital, but also allows for governments to interfere in economic activities in order to achieve social aims. In the real world most countries practice a mixed economy. (01 mark)

- (b) - Public and private ownership of resources
 - Existence of state and private enterprise
 - Protection of private property
 - Regulation of private sector
 - Prices are allowed to float along with supply and demand (price mechanism)
 - Government helps to control income disparity
 - Government encourages the private sector by providing them with infrastructure and other facilities
 - Taxation and government expenditure (use of fiscal policy)

(01 mark each for any four activities; Total marks 04)

02	
2. (i) Outline two possible exceptions to the Law of demand.	(04 marks)
(ii) Suppose a consumer buys 22 litres of petrol when the price is Rs. 140 per litre and when the price increases to Rs. 160 per litre, the consumer buys 18 litres. Calculate the price elasticity of demand of this consumer.	(04 marks)
(iii) If the price of an inferior good falls, assuming all other things remain constant, will the quantity demanded of the good decrease or increase? Explain your answer with reference to the substitution and income effects.	(06 marks)
(iv) Explain with the aid of diagrams, three factors that would cause a shift in the supply curve.	(06 marks)

2. (i) - Status symbol/ Conspicuous consumption/ Snob demand (Veblin goods)
 - Judging quality by price
 - Giffen goods:

(02 marks each for any two exceptions; Total marks 04)

- (ii) - Arc price elasticity formula (mid-point method) needs to applied in this case:

$$\text{Arc Elasticity} = \frac{\Delta Q}{\Delta P} \times \frac{P_1 + P_2}{Q_1 + Q_2} \quad (01 \text{ mark})$$

$$= -\frac{4}{20} \times \frac{140 + 160}{22 + 18} \quad (01 \text{ mark})$$

$$= -\frac{4}{20} \times \frac{300}{40} = -1.5 \quad (02 \text{ mark})$$

(No marks are given for the elasticity calculation based on point elasticity formula)

- (iii) – If the price of an inferior good falls, given the other things constant, the quantity demanded of the good increases.

- As the relative price of the inferior good falls, the quantity demanded of the good increases due to substitution effect. Since substitution effect always has an inverse relationship with relative price change, the quantity demanded of the good increases when the relative price falls.

(02 marks)

- When the price of an inferior good falls, the quantity demanded of the good decreases due to income effect. Since the income effect of an inferior good is always negative, the increase in real income due to price fall causes the quantity demanded to decrease.

(02 marks)

- In the case of inferior goods, the expansionary effect of the substitution effect dominates the contractionary effect of the income effect. The total price effect of fall in price of an inferior good results in the quantity demanded to rise.

(02 marks)

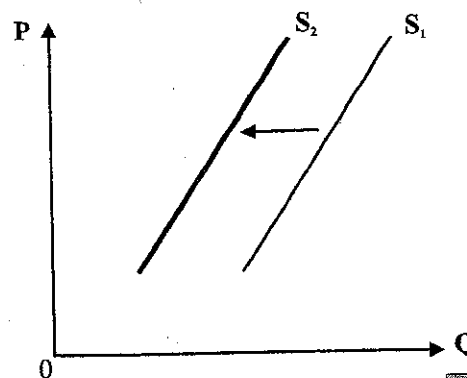
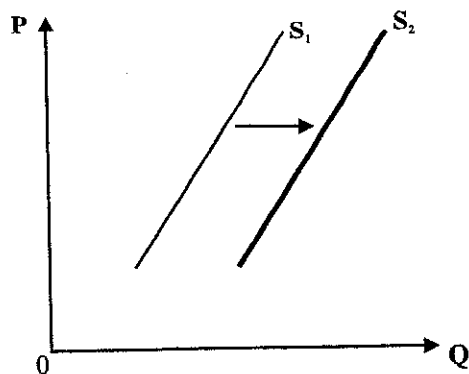
(Total marks 06)

- (iv) Change in any factor given below would shift the supply curve.

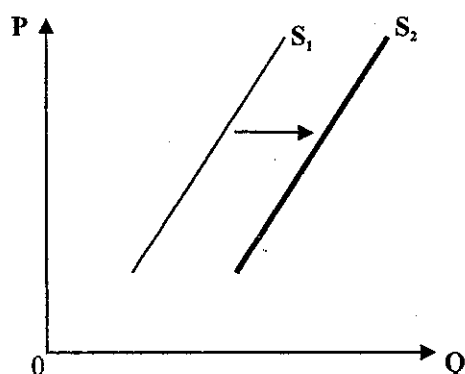
- Cost of factor inputs
- Number of sellers in the market
- Technology
- Taxes and subsidies
- Prices of related goods in production
- Unplanned factors (weather conditions etc.)
- The candidate has to identify three factors that would cause shifts in the supply curve and explain with the help of diagrams how does the change in those factors cause shifts in the supply curve.
- Examples:

Decrease in input prices
causes supply curve to
shift to the right.

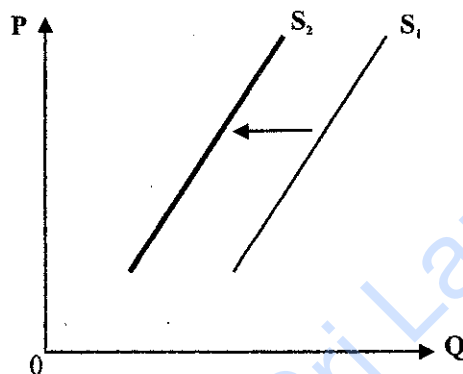
Increase in input prices
causes supply curve to
shift to the left



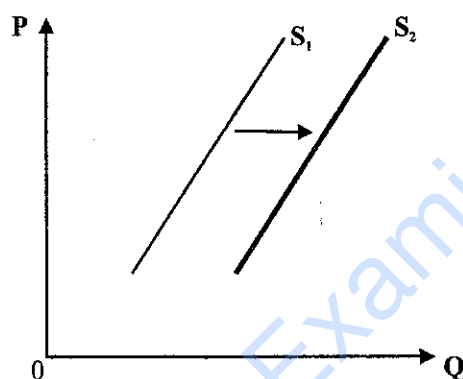
Increase in the number of suppliers causes supply curve to shift to the right.



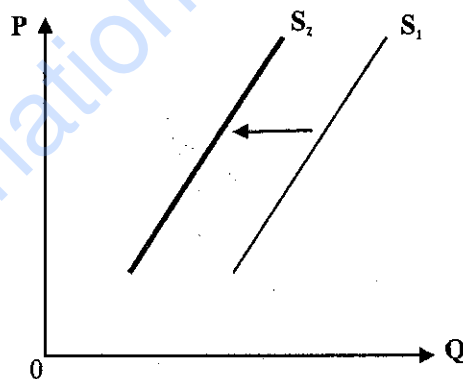
Decrease in the number of suppliers causes supply curve to shift to the left.



Improvement in technology causes supply curve to shift to the right.



Decline in technology causes supply curve to shift to the left.



(02 marks each for any factor with explanatory diagrams; Total marks 06)

03	
3. (i) Define consumer surplus and producer surplus.	(04 marks)
(ii) Explain using a diagram how a price ceiling creates a deadweight loss.	(04 marks)
(iii) Suppose the government has offered onion farmers a price support of Rs. 100 per kilogram and the excess supply is purchased by the government at the support price. Market demand and supply equations are given below.	
Demand: $Q_D = 240 - 2P$	Supply: $Q_S = -210 + 3P$
(a) How much does this price support programme cost the government?	(04 marks)
(b) What is the amount of consumer surplus and producer surplus after the price support?	(04 marks)
(c) Calculate the deadweight loss due to price support.	(04 marks)

03. (i) – Consumer surplus is the difference between what a person is willing to pay for an additional unit of a good (the marginal benefit) and the market price of the good.

- When the consumer purchases several units of a particular good, the total (accumulated) consumer surplus is the sum of individual surpluses over the quantity purchased. It is given by the area between individual demand curve and the market price line.

- Consumer surplus for the market is the sum of the individual consumer surpluses. It is given by the area between market demand curve and the market price line.

(02 marks)

- Producer surplus is the price a firm receives for selling an additional unit of a product minus marginal cost (the minimum supply price) of producing it.

- When a firm sell several units of a particular product, the total producer surplus is the sum of individual surpluses over the quantity sold. It is given by the area between firm's supply curve and the market price line.

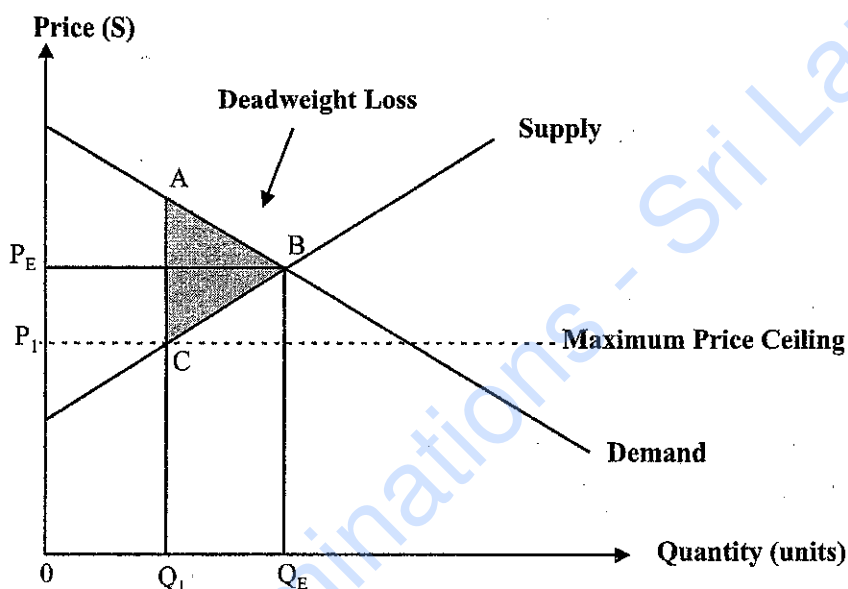
OR

- Total producer surplus of the firm is the difference between total revenue and the total variable cost at the quantity of output sold.

- Producer surplus for the market as a whole is the sum of all the individual firms' producer surpluses. It is given by the area above the market supply curve and below the market price line.

(02 marks)

- (ii) - When a price ceiling is below the market equilibrium price, the price is forced below the equilibrium price and the quantity produced shrinks resulting a shortage. A deadweight loss arises. (01 mark)
- Deadweight loss is the loss in total surplus that occurs whenever an action or a policy reduces the quantity transacted below the efficient market equilibrium quantity. (01 mark)



- According to the above diagram, market equilibrium price is P_E and the price ceiling is P_1 . As price ceiling has been fixed below the equilibrium price, the quantity supplied at the ceiling price is Q_1 which is less than the market equilibrium quantity of Q_E .
- As a result of the reduction in the quantity supplied at ceiling price, the economic surplus enjoyed by both buyers and sellers at the equilibrium price has been reduced by the area denoted by ABC triangle. This loss of welfare to the society is known as deadweight loss.

(01 mark for the correct diagram and 01 mark for the explanation using diagram;
Total marks 04)

- (iii) (a) The cost to the Government:

At support price quantity of market demand = $240 - 2(100)$;

$$240 - 200 = 40 \text{ units} \quad (01 \text{ mark})$$

At support price quantity of market supply = $-210 + 3(100)$;

$$-210 + 300 = 90 \text{ units}$$

(01 mark)

$$\text{Excess supply } Q_s - Q_d = 90 - 40 = 50 \text{ units}$$

(01 mark)

$$\text{Cost to the Government} = 50 \times 100 = \text{Rs. } 5000$$

(01 mark)

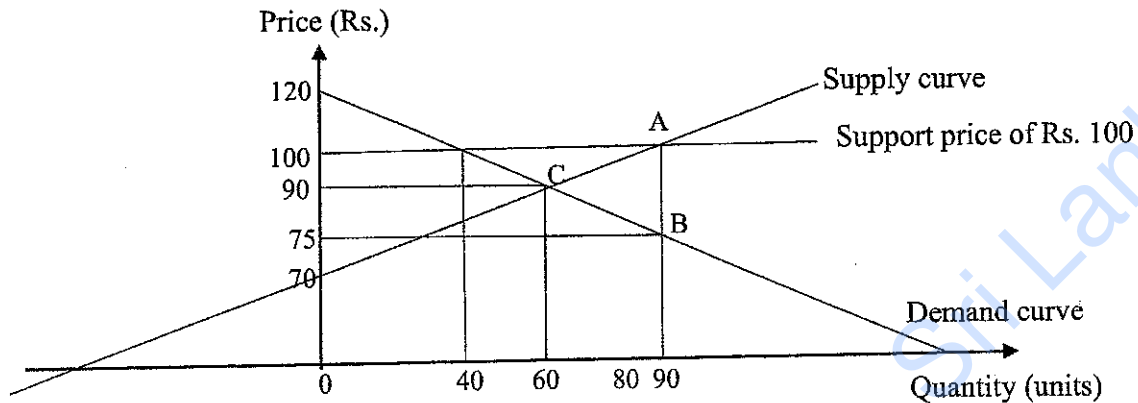
(b) - Unregulated market equilibrium:

(Demand) $Q_d = 240 - 2P$

(Supply) $Q_s = -210 + 3P$

$240 - 2P = -210 + 3P$

$5P = 450; \quad P = 90 \quad Q = 60$



- Consumer surplus after the price support: $= \{(120 - 100) \times 40\} \div 2 = \text{Rs. } 400$
(02 marks)

- Producer surplus after the price support: $= \{(100 - 70) \times 90\} \div 2 = \text{Rs. } 1350$
(02 marks)

(c) - The deadweight loss as a result of price support: Deadweight loss is the loss in total surplus that occurs whenever an action or a policy increases the quantity transacted above the efficient market equilibrium quantity. Equilibrium quantity is 60 but due to price support policy suppliers are encouraged to produce 90 units.

- There is an overproduction of 30 units ($Q_D = 60; Q_S = 90$). This reflects inefficient utilization of resources. Each additional unit produced above 60 units causes welfare loss because minimum supply price (marginal cost) of each unit exceeds its demand price (marginal benefit). The area of the ABC triangle represents the deadweight loss.

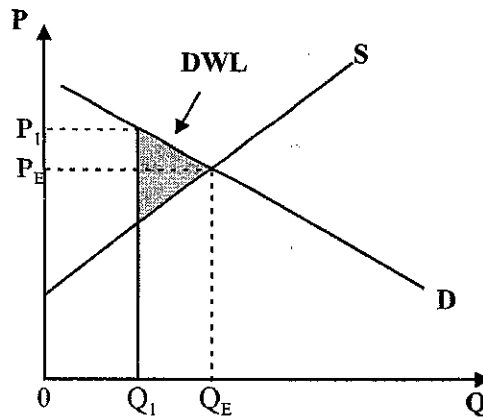
- Deadweight loss $= \{(100 - 75) \times 30\} \div 2 = \text{Rs. } 375$ (02 marks)

Note

The concepts of 'deadweight loss' and 'loss of economic surplus' are not identical concepts though they are used interchangeably by many teachers. The term deadweight loss (DWL) refers to the reduction in consumer surplus and producer surplus that results from producing an inefficient quantity of output. It is a measure of inefficiency in resource allocation. The loss of economic surplus or welfare surplus refers to the reduction in total welfare in society due to government policy interventions. This welfare reduction may not only be due to the decrease in

consumer and producer surpluses, but also due to increase in public expenditure (taxpayers' resources) associated with government intervention into market.

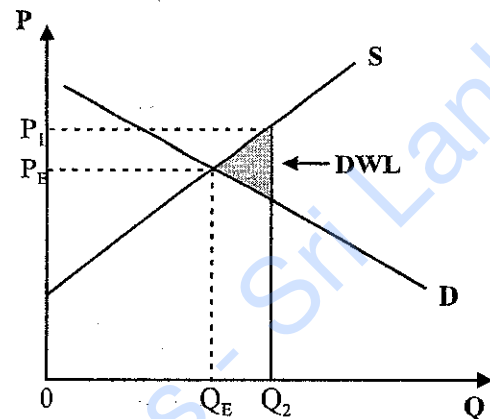
The deadweight loss specifically refers to the reduction in consumer and producer surpluses owing to overproduction or underproduction.



DWL due to underproduction

Q_E = Equilibrium output

Q_I = underproduction



DWL due to overproduction

Q_E = Equilibrium output

Q_I = overproduction

Deadweight loss is also known as welfare triangle or Harberger triangle.

(iii) (c) **Alternative answer:**

[Many candidates seem to have failed to distinguish between deadweight loss and reduction in welfare. Considering this limitation, an alternative answer is given suggested as given below.)

- Deadweight loss due to support price = Change in economic surplus due to price support - Cost of the government to implement price support

- Consumer surplus before price support = $\{(120 - 90) \times 60\} \div 2 = 900$

- Producer surplus before price support = $\{(90 - 70) \times 60\} \div 2 = 600$

- Economic surplus before price support = $900 + 600 = 1500$

(01 mark)

- Consumer surplus after price support = $\{(120 - 100) \times 40\} \div 2 = 400$

- Producer surplus after price support = $\{(100 - 70) \times 90\} \div 2 = 1350$

- Economic surplus after price support = $400 + 1350 = 1750$

(01 mark)

$$\text{Change in economic surplus after support price} = 1750 - 1500 = 250$$

Change in total welfare after price support = Change in economic surplus –
Cost of the government to
implement price support

Cost of the government to implement price support = $100 \times 50 = 5000$

Change in total welfare (deadweight loss) = $250 - 5000 = -4750$

Reduction in total welfare by 4750

(02 marks)

(Total marks 04)

04	
4. (i) Define the concept of 'normal profit'.	(02 marks)
(ii) Classify the following expenditure into fixed cost and variable cost.	
(a) Raw material	
(b) Rent of the factory buildings	
(c) Interest on borrowings	
(d) Fertilisers	(1 × 4 = 04 marks)
(iii) Compare perfectly competitive market structure with monopoly.	(04 marks)
(iv) "In the short run firms may stay in the industry even if they are making a loss." Explain this statement.	(04 marks)
(v) "A computer software engineer who was earning a salary of Rs. 200 000 per month decided to become an entrepreneur and started her own software development firm in which she earns Rs. 500 000 per month."	
(a) What is this entrepreneur's transfer earning?	(03 marks)
(b) Does this entrepreneur earn an economic rent? Explain your answer.	(03 marks)

04. (i) – Normal profit is the minimum payment that the entrepreneur expects to receive in order to keep his service available in the present use.

- Since it is a payment to be made for performing entrepreneurial functions in the organization, the normal profit is an implicit cost of the firm. Unless this payment is received by the entrepreneur, he/she would withdraw his/her entrepreneurship from the organization.

(02 marks)

- | | |
|----------------------------------|-----------------|
| (ii) (a) Raw material | - Variable cost |
| (b) Rent of the factory building | - Fixed cost |
| (c) Interest on borrowings | - Fixed cost |
| (d) Fertilizers | - Variable cost |

(01 mark each and Total marks 04)

(iii) Comparison of Perfect competition with Monopoly:

Perfect Competition	Monopoly
(i) There are a large number of sellers with a large number of buyers offering homogenous products.	There is only one single seller of a commodity with a large number of buyers.
(ii) In this market, the sellers are known as price takers.	In this market, the sellers are price makers.
(iii) This market has strong competition in the market.	There is no competition in the market.
(iv) Firm's demand curve is perfectly elastic	Firm's demand curve is downward sloping
(v) Here, the sellers don't have any control over the price.	In this market, the seller has full control over the price.
(vi) Here, there are no restrictions or barriers for new firms to enter the market.	It has strong restrictions for the entry of new firms into the market.
(vii) There is no price discrimination by sellers as the prices are determined by supply and demand forces.	The monopolist can charge different prices from different groups of buyers.
(viii) Here, the supply curve can be identified as all firms sell the desired quantity at the prevailing price.	In a monopoly, the supply curve cannot be known because of price discrimination.

(01 mark each for any four differences; Total marks 04)

- (iv) - In the short run, a firm that is operating at a loss (where the revenue is less than the total cost or the price is less than the unit cost) must decide to operate or temporarily shutdown. The shutdown rule states that "in the short run a firm should continue to operate if price exceeds average variable costs".

(01 mark)

- If a firm shuts down, it produces no output and it incurs a loss equal to total fixed cost which is unavoidable. This loss is the largest that a firm need incur. Therefore, the rational decision for the firm incurring losses in the short run would be to continue its production as long as its total revenue exceeds its total variable costs.

(01 mark)

- When determining whether to operate, a firm has to compare the total revenue to the total variable costs. If the total revenue the firm is making is greater than the total variable cost ($TR > TVC$) then the firm is covering its variable costs and there is additional revenue to partially cover the fixed costs.

(01 mark)

- On the other hand, if the variable cost is greater than the revenue being made ($TVC > TR$) then the firm is not even covering production costs and it should be shutdown immediately.

(01 mark)

(Total marks 04)

- (v) (a) This entrepreneur's transfer earning (minimum supply price) is Rs. 200,000 per month.

(03 marks)

- (b) Yes. If the business performs as expected, the entrepreneur will earn an economic rent. As her transfer earning is Rs. 200,000 per month, she will earn Rs. 300,000 monthly as economic rent.

(03 marks)

(Total marks 06)

05

5. (i) In national income accounting, indicate the institutional sector to which the following units belong.

- (a) Fishermen's Cooperative Society
- (b) Southern Provincial Council
- (c) National Chamber of Commerce
- (d) Sri Lanka Insurance Corporation

(1×4 = 04 marks)

- (ii) Consider the following macroeconomic data for an open economy.

Gross Domestic Product (Y) = 500

Consumption (C) = 350

Taxes – Transfers (Net Taxes) = 20

Investment (I) = 150

Budget deficit = 120 (All figures are in billion Rupees.)

What is the value of net exports in this economy?

(04 marks)

- (iii) Suppose in a hypothetical closed economy, equilibrium national income is Rs. 800 billion, Marginal Propensity to Consume (MPC) is 0.8 and the potential output level is Rs. 1 000 billion.

- (a) Is this economy facing a recessionary gap or inflationary gap?

What is the size of this gap?

(02 marks)

- (b) If the Government intends to remove this gap using direct taxes, what would be the required change in direct taxes?

(02 marks)

- (iv) The table below gives some data related to national accounts of a country.

Item	Value (Rs. billion)
Gross value added at basic price	11 500
Net Primary Income from the rest of the world	-300
Taxes less subsidies on products	800
Consumption expenditure	8 500
Net current transfers from the rest of the world	900

Based on the above data compute the following.

- (a) Gross Domestic Product
- (b) Gross National Income
- (c) Gross National Disposable Income
- (d) Domestic Savings

(2×4 = 08 marks)

5. (i) (a) Fishermen's Cooperative Society - Non-Financial Corporate Sector
 (b) Southern Provincial Council - General Government Sector
 (c) National Chamber of Commerce - Non-profit institutions serving households sector
 (d) Sri Lanka Insurance - Financial Corporations Sector
 (e) Buddhist temples - Household Sector

(01 x 4 = 04 marks)

- (ii) - Gross Domestic Product (GDP) = $C + I + G + NX$
 - Net Exports (NX) = $GDP - (C + I + G)$ (01 mark)
 - Budget Deficit (BD) = $G - \text{Net Taxes } (T - Tr) = 120$
 $BD = G - 20 = 120$
 $G = BD + \text{Net Taxes } (T - Tr)$
 $G = 120 + 20 = 140$ (01 mark)
- Net Exports (NX) = $Y - (C + I + G)$
 $NX = 500 - (350 + 150 + 140)$ (01 mark)
- Net Exports = $500 - 640 = -140$
 = Rs. -100 billion (01 mark)
- (Total marks 04)
- (iii) (a) - This economy is facing a recessionary gap because its real output level (Rs. 800 billion) is less than its potential output level of (Rs. 1000 billion). (01 mark)
 - The size of the recessionary gap is Rs. 200 billion (1000 - 800). (01 mark)
- (b) - Tax multiplier = $\frac{b}{1 - b} = \frac{0.8}{1 - 0.8} = \frac{0.8}{0.2} = 4$ (01 mark)
 - Recessionary Gap = Rs. 200 billion
 - To remove the recessionary gap of Rs. 200 billion, a reduction in direct taxes by Rs. 50 billion ($200 \div 4$) is required, (01 mark)
- (Total marks 04)
- (iv) (a) Gross Domestic Product = Gross Value added at basic price + Taxes less subsidies on products (01 mark)
 Gross Domestic Product = $11,500 + 800 = \text{Rs. } 12,300$ billion (01 mark)
- (b) Gross National Income = Gross Domestic Product + Net Primary Income from the rest of the world (01 mark)
 Gross National Income = $12,300 + (-300) = \text{Rs. } 12,000$ billion (01 mark)
- (c) Gross National Disposable Income = Gross National Income + Net current transfers from the rest of the world (01 mark)

Gross National Disposable Income = 12,000 + 900 = Rs. 12,900 billion

(01 mark)

(d) Domestic Savings = Gross Domestic Product – Consumption Expenditure

(01 mark)

$S_D = 12,300 - 8,500 = \text{Rs. } 3,800 \text{ billion}$

(01 mark)

(Total marks 08)

Sub section 'B'

(Select minimum of two questions from this section.)

06	
6. (i) What are the main functions of money?	(04 marks)
(ii) What are the factors that might affect the money creating potential of the banking system?	(04 marks)
(iii) How does a commercial bank manage its assets structure in pursuing two conflicting goals?	(06 marks)
(iv) What are the key features of the monetary policy adopted by the Central Bank of Sri Lanka to address the financial distress of households and enterprises created by COVID-19 pandemic?	(06 marks)

6. (i) - Medium of exchange
 - Measure of value
 - Standard of deferred payments
 - Store of value

(01 mark each and Total marks 04)

- (ii) - Creditworthy customers
 - Demand for loans
 - Cash deposits in the bank
 - Peoples' preference for currency
 - Currency drains from the banking system to non-bank financial institutions
 - Banks' willingness to keep excess reserves
 - Central Bank's monetary policy

(01 mark each; Total marks 04)

- (iii) - The asset items on a commercial bank's balance sheet reflect the banker's pursuit of two conflicting goals: profit and safety (liquidity).

(02 mark)

- Commercial banks like any other businesses, seek profits, which is why the bank makes loans and buys securities- the two major earning assets of commercial banks. The other goal is safety. For a bank, safety lies in liquidity,

especially such liquid assets as cash and excess reserves. Banks need to hold adequate reserves to meet its depositors' demand for cash.

(02 mark)

- Banks have a strong incentive to invest in assets that earn a high return. Generally, however, assets that earn the higher returns tend to be relatively illiquid. On the other hand, too much attention on liquidity would tend to affect the profitability if banks are keeping much of cash reserves greater than that amount required. Bank will miss opportunities of providing the finance, lending and investment which is generating profit.

(01 mark)

- This creates a conflict between two goals. One of the arts of bank management is balance the bank's portfolio of assets between profit and liquidity. In fact, banks keep only a small fraction of its funds in liquid assets and the rest is in earning assets which include investment in securities and loans.

(01 mark)

(Total marks 06)

- (iv) - The Central Bank of Sri Lanka reduced the key policy interest rates, namely the Standing Deposit Facility Rate (SDFR) and Standing Lending Facility Rate (SLFR), to their historically lowest levels of 4.50% and 5.50% respectively during 2020.
- The Statutory Reserve Ratio (SRR) on all rupee deposit liabilities of licensed commercial banks (LCBs) was reduced on two occasions by a total of 3 percentage points to 2% during 2020 thereby increasing liquidity in the domestic money market amidst heightened uncertainty emanating from cash flow disruptions and urgent funding requirements of financial institutions.
- In April 2020, the Central Bank reduced the Bank Rate, which is an administratively determined rate that could be used in periods of emergency, by 500 basis points from 15 per cent to 10 per cent.
- A wide ranging debt moratorium was announced for the tourism, plantation, IT and apparel sectors, related logistics providers and small and medium scale enterprises. These businesses are also to receive working capital loans and investment purpose loans at concessional rates.
- Moratoria have also been granted on leasing loans for three wheelers, small value personal banking and leasing loans.
- In addition, financial institutions have been requested to reschedule non performing loans.

- The Central Bank implemented regulatory measures to reduce excessive interest rates charged on certain financial products, including credit cards and pawning, thereby helping marginal borrowers.
- A maximum interest rate of 7.00 per cent per annum was imposed on Mortgage-backed housing loans.
- The Central Bank implemented concessional loan schemes under the Saubagya COVID-19 Renaissance Facility, enabling licensed banks to grant working capital loans at a concessional rate of 4.00 per cent to adversely affected businesses to revive their activities.

(01 mark each for any policy measure; Total marks 06)

07	
7. (i) Why in a market economy, some goods and services are over-consumed and some are under-consumed?	(04 marks)
(ii) Outline the main differences between pure private goods and pure public goods.	(04 marks)
(iii) State two arguments in favour of privatisation and two arguments against privatisation.	(04 marks)
(iv) Explain the economic consequences of widening budget deficit.	(08 marks)

7. (i) - This situation reflects market failure due to externalities in consumption. Externalities in consumption cause divergence between private and social benefits. Market failure occurs when the price mechanism fails to account for all of the costs and benefits associated with the consumption of a good. The market will fail to produce socially optimal level of consumption.
- (02 marks)

- When negative externality exists in consumption, private benefit exceeds social benefit resulting over consumption.

(01 mark)

- When positive externality exists in consumption, social benefit exceeds private benefit resulting under-consumption.

(01 mark)

(Total marks 04)

(ii)

Pure Private goods	Pure Public Goods
(i) Consumption is rival	Consumption is non-rival
(ii) Consumers can be excluded	Exclusion impossible
(iii) Can be rejected	Cannot be rejected
(iv) Market supplies	Market fails to supply

(01 mark each for any difference and total marks 04)

(iii) Arguments in favour of privatization:

- More revenue for the government
- More competition
- Enterprise culture
- Shedding of loss making state enterprise
- More competitive prices
- Improved quality
- Greater incentives for innovations
- Attraction of FDI

(02 marks)**Arguments against privatization:**

- Increased prices
- Falling standard of service
- Loss of jobs and reduce job security
- Loss of state resources/loss of annual profits
- Foreign ownership

(02 marks)**(Total marks 04)**

- (iv) - Increase of public debt: In order to finance the deficit the government will have to borrow from domestic and foreign sources. This leads to increase in the burden of debt over time
- Increase in inflation: When the government borrows money to finance budget deficit from the banking system money supply expands resulting inflationary pressures in the economy.
- Depreciation of external value of currency: Both the increase in domestic inflation and the debt service payments on foreign borrowing can lead to depreciation of the currency.
- Budget deficits crowd out private borrowing: Using domestic financial resources to finance budget deficits can result in a shortage of resources available for private investments.
- Increase in interest rates: The competition of both public and private sectors for a limited amount of financial resources could raise the interest rates in the economy resulting adverse impact on private sector investments,
- Balance of payments difficulties: Repayment of foreign debt can cause severe balance of payments problems.

- Macroeconomic instability: Excessive monetary expansion, depreciation of currency and rising interest rates are harmful to macroeconomic stability which is essential to achieve a sustainable rate of economic growth.

**(02 marks each for any four impacts with explanations;
without explanation 01 mark for each impact; Total marks 08)**

08	
8. (i)	Suppose that, with the same resources, country A can produce either 40 Cars or 40 tons of Food and country B can produce either 60 Cars or 30 tons of Food.
(a)	What is each country's internal exchange rate in the absence of specialisation? (02 marks)
(b)	Are there comparative advantages in these countries in the production of above goods? Explain the answer. (04 marks)
(ii)	What is the difference between net exports and the current account balance in the Balance of Payments statement? (04 marks)
(iii)	Outline four main factors cause the demand and supply curves to shift in the foreign exchange market (04 marks)
(iv)	What is the role of Central Bank in the following exchange rate systems?
(a)	fixed exchange rate system (03 marks)
(b)	managed floating exchange rate system (03 marks)

08. (i) (a) Internal rate of exchange is determined by the ratio of opportunity cost between goods.

Country A's opportunity cost ratio: 40 cars : 40 tons of food

1 car : 1 ton of food (01 marks)

Country B's opportunity cost ratio : 60 cars : 30 tons of food

1 car : 0.5 tons of food or
1 ton of food : 2 cars (01 marks)

- (b) Since opportunity cost ratios are different in the two countries comparative advantages exist for both countries.

Country	Opportunity cost of producing Cars	Opportunity cost of producing Food
A	1 car = 1 ton of food	1 ton of Food = 1 car
B	1 car = 0.5 tons of food	1 ton of food = 2 cars

(02 marks for the calculation of opportunity costs)

- Country A has lowest opportunity cost for the production of food. Therefore country A has the comparative advantage in the production of food.
- Country B has lowest opportunity cost for the production of cars. Therefore country B has the comparative advantage in the production of cars.

(02 marks for the explanation)

(Total marks 06)

- (ii) – The difference between the value of exports of goods and services and the value of goods and services imports is Net Exports.

OR

- The sum of trade balance and the service account balance in the current account of the Balance of Payments is Net Exports.

(02 marks)

- Current account balance comprises of Net Exports, Net Primary Income and Net Secondary Income.

OR

- Current account balance is the total sum of trade balance, service account balance, primary income account balance and the secondary income balance.

(02 marks)

(Total marks 04)

- (iii) –
- Changes in the demand for locally produced goods and services
 - Changes in demand for foreign-produced goods and services
 - Changes in the desire to invest locally
 - Changes in the desire to invest in foreign countries
 - Changes in the expectations of currency traders about the likely future value of the domestic currency and the likely future value of foreign currencies
 - Differences across countries in rates of return on investment
 - Changes in relative inflation
 - Change in political and economic stability
 - Changes in the level of government debt
 - Changes in relative income levels of countries

(01 mark each for any four factors; Total marks 04)

- (iv) (a)- Fixed exchange rate system: A Central Bank actively uses its foreign currency reserves to maintain the officially determined exchange rate.

(01 mark)

- When there is an excess demand for foreign currency (i.e. US dollars) in the foreign exchange market the Central Bank would immediately satisfy the excess demand by supplying additional foreign currency (US dollars) to the market.

(01mark)

When there is an excess supply of foreign currency (i.e. US dollars) in the foreign exchange market, the Central Bank would remove the excess supply by purchasing additional foreign currency. By doing so, it can maintain a credible fixed exchange rate.

(01 mark)

- Managed Floating: A Central Bank enters the foreign exchange market to buy/sell foreign currency in order to control fluctuations and volatility in the market. (01mark)
 - When there is a tendency for a depreciation of its own currency in the foreign exchange market, Central Bank actively manages its exchange rate buying its own currency. This helps to prevent further depreciation of the currency. (01 mark)
 - When there is a tendency for an appreciation of its own currency in the foreign exchange market, Central Bank actively manages its exchange rate selling its own currency (absorption). This helps to prevent further appreciation of the currency. (01 mark)
- (Total marks 06)

09	
9. (i) What is economic growth? How does it differ from rate of economic growth?	(04 marks)
(ii) "Development is a multi-dimensional process". Explain.	(04 marks)
(iii) Compare the sectoral composition of total employment (agriculture, industry and services) with the sectoral composition of Gross Domestic Product of Sri Lanka at present.	(06 marks)
(iv) What is Sri Lanka's current position in the following key indices guiding investors?	
(a) Ease of Doing Business Index	(02 marks)
(b) Global Competitiveness Index	(02 marks)
(c) Corruption Perception Index	(02 marks)

09. (i) - Economic growth can be defined as an expansion of the productive capacity (potential output) of the economy over time to bring about rising level of national output and income. It is a dynamic process in which supply, demand and efficiency factors all interact. (02 marks)
- Rate of economic growth measures change in real GDP or GNP between two time periods. (01 mark)
 - The rate of economic growth measures the actual rate of change of output whereas economic growth measures the growth of potential output capacity of the economy. (01 mark)
- (Total marks 04)

- (ii) - Development is a multi-dimensional process in which both the non-economic dimensions and the economic dimensions are important. Development thus, results in the simultaneous achievement of a number of objectives such as growth and equity.

(01 mark)

- Development is the improvement of the quality of life. The term 'multidimensional development' recognises that development is not one thing. Rather, development is a broad term that includes lots of possible factors, such as: social development, economic development, Environmental management, gender equality, political empowerment, demographic development.

(02 marks)

- The widely used multidimensional indicator of development is the Human Development Index (HDI). The HDI uses three broad areas of development - Economic: "a decent standard of living", measured as Gross National Income per capita at Purchasing Power Parity, Social: "a long and healthy life", measuring using life expectancy at birth, Social: "knowledge", measured as a combination of mean years of schooling and expected years of schooling'

- The HDI simplifies and captures only part of what human development entails. It does not reflect on inequalities, poverty, human security, empowerment, etc.

(01 mark)

(Total marks 04 marks)

(iii)

Sector	2020		2019	
	GDP	Employment	GDP	Employment
Agriculture	7.0%	27.1%	6.9%	25.3%
Industry	25.5%	26.9%	26.4%	27.6%
Services	58.7%	46%	57.5%	47.1%

(01 mark for any correct figure; Total marks 06)

(iv)

Index	Sri Lanka's latest Global Ranking
Ease of Doing Business Index (2020)	99/190
Global Competitiveness Index (2019)	84/141
Corruption Perception Index (2020)	94/180
	102/180 (2021)

(02 marks for each Index; Total marks 06)

10		
10.	(i) What is a currency swap agreement? Give an example from Sri Lanka.	(04 marks)
	(ii) Outline the key problematic areas in the Sri Lankan economy which hinder investor confidence and competitiveness.	(04 marks)
	(iii) What are the policy recommendations you may suggest to overcome the foreign exchange crisis which Sri Lankan economy is facing at present?	(04 marks)
	(iv) Briefly describe using appropriate data, how the Sri Lankan economy has performed, in the recent years with respect to the rate of economic growth, budget deficit, trade deficit and public debt.	(08 marks)

10. (i) - A currency swap is a transaction in which two parties exchange an equivalent amount of money with each other but in different currencies.

- Currency swaps are often offsetting loans, and the two sides often pay each other interest on amounts exchanged. In a currency swap, the counter-parties exchange given amounts in the two currencies. For example, one party might receive 100 million British pounds (GBP), while the other receives \$125 million. This implies a GBP/USD exchange rate of 1.25. At the end of the agreement, they will swap again at either the original exchange rate or another pre-agreed rate, closing out the deal.

(02 marks)

- Examples:

Examples: Sri Lanka originally signed the swap deal (USD 400) available to SAARC countries in 2020 and repaid it in February 2021 after rolling it over once. On 24th July 2020 under the Framework on Currency Swap Arrangement for South Asian Association for Regional Cooperation (SAARC) countries for 2019 - 2022. This would provide short-term financing to the CBSL to meet the country's balance of payment requirements.

- The Central Bank of Sri Lanka (CBSL) and the People's Bank of China (PBoC) entered into a bilateral currency swap agreement in 2021. Under this agreement, CBSL is entitled for a swap facility amounting to CNY 10 billion (approximately US\$ 1.5 billion). The agreement is valid for a period of three (3) years.

- Bangladesh in May 2021 cleared a \$200 million currency swap facility for Sri Lanka, to help boost its economy, becoming the first South Asian country to extend crucial financial assistance to the island nation this year.

(02 marks for any one example)

(Total marks 04)

- (ii) - Macroeconomic instability
 - Restrictive labour regulations
 - Lack of policy consistency
 - Corruption
 - Inefficient tax system
 - Complexity in the tariff structure
 - Poor ICT adoption
 - Inefficient legal processes
 - Poor Infrastructure Network
 - Inefficient government bureaucracy
 - Insufficient capacity to innovate

(01 mark each for any four reasons; Total marks 04)

(iii) **Short term policies:**

- Restriction of non-essential imports
- Rescheduling programme for existing debts
- Allowing exchange rate to be market determined
- Swap agreements
- Obtain assistance from the IMF

Long Term Policies:

- Reviving of the export sector
- Maintain macroeconomic stability
- Obtain access to global production networks
- Explore the avenues for favourable free trade agreements
- Create a conducive environment for FDI
- Investment in R & D
- Strengthen the efficient import substitution programmes
- Provide more facilities to migrant workers

(01 mark each for any four factors; Total marks 04)

- (iv) - **Rate of Economic growth:** Sri Lanka has failed to achieve a sustained rate of economic growth in the recent years. Economic growth rates have reached lowest levels in the last few years. (01 mark)

- Rate of economic growth: 2018: 3.3%; 2019: 2.3%; 2020: -3.6%

(01 mark)

- **Budget Deficit:** Budget deficits have widened in the last two years amidst notable decline in government revenue and the sharp rise in recurrent

expenditure along side the contraction of economic activity due to the Covid-19 pandemic. (01 mark)

- **Budget deficit as a percentage of GDP:**

2018: 5.3%; 2019: 9.6%; 2020: 11.1% (01 mark)

- **Trade deficit:** Trade deficit has continued to contract notably in the recent years to record the lowest trade deficit since 2010. The overall contraction in the trade deficit in the last two years was driven by a significant reduction in the expenditure on merchandise imports. (01 mark)

- **Trade Deficit:** 2018: \$ 10,343 million; 2019: \$ 7997 million; 2020: \$ 6008 million Trade Deficit as a Percentage of GDP: 2018: 11.7% 2019: 9.5%; 2020: 7.4% (01 mark)

- **Public Debt:** Outstanding public debt has continued to increase in nominal terms in every year but its growth rate has accelerated in recent years. Decline in government revenue and the rise recurrent expenditure mainly contributed to the sharp increase in public debt both in nominal terms and as a percentage of GDP. (01 mark)

- **Outstanding Public Debt:**

- **Total Outstanding Central Government Debt:**

2018: Rs. 12031 billion (83.7% of GDP);
2019: Rs. 13,032 billion (86.8% of GDP)
2020: Rs. 15,117 billion (101% of GDP)

- **Total Outstanding Public Debt:**

2018: Rs. 13,178 billion (91.7% of GDP);
2019: Rs. 14,155 billion (94.3% of GDP)
2020: Rs. 16,427 billion (109.7% of GDP)

(01 mark)

(Total marks (08))