



Association of Accounting Technicians of Sri Lanka

Level I Examination – July 2023

Suggested Answers

(103) ECONOMICS (ECN)

Association of Accounting Technicians of Sri Lanka

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THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

Level I Examination - July 2023

(103) ECONOMICS

SUGGESTED ANSWERS

(Total 40 Marks)

SECTION - A

Suggested Answers to Question One:

1.1 (3)

1.2 (3)

1.3 (1)

1.4 (2)

1.5 (4)

1.6 (3)

1.7 (4)

1.8 (1)

1.9 (3)

1.10 (2)

1.11 Macro

1.12 Left

1.13 False

1.14 True

1.15 Characteristics of Economic Goods

(Stating any of the two characteristics mentioned below would permit full marks.)

- Existence of Limitation / Scarcity in supply
- Existence of cost of resources
- Existence of Opportunity Cost
- Most economic goods are having a price
- Economic goods are an outcome of a production process
- Existence of a clear ownership

1.16 Characteristics of an Oligopoly Market

(Stating any of the two characteristics mentioned below would permit full marks.)

- Only a few firms operate in the entire market
- The existence of entry/exit barriers
- Existence of interdependence among the firms in the industry
- Firms producing identical or differentiated products
- The firms in an Oligopoly market face a relatively inelastic, downward-sloping demand curve

1.17 Factors affecting the Money Supply of a country

(Stating any of the two factors mentioned below would permit full marks.)

- Net Domestic Assets held by the Banking System
- Net Foreign Assets held by the banking system
- Other net assets held by the banking system

1.18 Narrow Money Supply (M_1)

This includes the money held for transaction motive and money which facilitates the Medium of exchange function.

$$M_1 = C_p + DD_p$$

Where,

M_1 = Narrow Money Supply

C_p = Currency held by the public

DD_p = Demand deposits held by the public at commercial banks

Broad Money Supply (M₂)

This definition includes all items mentioned in the Narrow Money Supply and Money held for precautionary motive and money, which facilitates the store of the value function.

$$M_2 = M_1 + TSD_{CP}$$

Where,

M₂ = Broad Money Supply

M₁ = Narrow Money Supply

TSD_P = Time and saving deposits held by the public at commercial banks

1.19 The Determinants of Price Elasticity of Demand

(Mentioning any two of below mentioned determinants would permit full marks.)

- Availability of Substitutes
- Type or Nature of the Product (Whether it is a Luxury or Necessity)
- Income Level or Proportion of the income spent on the good
- Time Horizon
- Number of alternative usages of a given product

1.20 Achieving the equilibrium by a firm under the perfect competition in the short-run

Perfectly Competitive firms achieve equilibrium at the point where its Marginal Cost (MC) is equivalent to Marginal Revenue (MR). Therefore, the output produced at the point where the firm's MC equals MR is the firm's optimum output, and this is the output that maximizes the firm's profit. In a perfectly competitive firm,

(02 marks each, Total 40 marks)

End of Section A

Suggested Answers to Question Two:***Chapter 01 - Economic Concepts and Systems Related to Business Environment***

(a)

Market Economic System***What to produce and in what quantities?***

What to produce refers to those goods and services and the quantity of each that the economy should produce. It is a problem of allocation of scarce resources which have alternative uses of resources among the various economic activities. This problem is common to all societies.

This problem is solved based on the commodity price by the price mechanism, which is guided by demand for goods and services. Private producers choose high-priced products and produce more quantities of high products and fewer quantities of low-price products. Accordingly, in the market economic system, enterprises use more resources in producing goods and services on which the profitability is higher.

How to produce?

How to produce refers to the choice of the combinations of factors and the particular technique to use in producing a good and service. Since a good or service can normally be produced with different factor combinations and different techniques, a problem arises as to which of these to use. This problem is common to all societies.

This problem is solved based on the factor price by the price mechanism. The technique with the least cost that ensures the maximum profitability is chosen in solving this question. Private producers choose low-price technology to maximize profit and minimize the cost of production.

To whom to produce?

For whom to produce refers to the determination in the distribution of national income among the factor owners of the economy. As resources are not enough to produce for every one of the societies, this problem is common to all societies.

This problem is solved based on the demand for goods and services by the price mechanism. The consumers' demand for goods and services produced in the economy is determined by the disposable income of the household. Private producers produce goods and services for

high-income people to maximize their profits.

Planned Economic System

What to produce and in what quantities?

The question of what to produce refers to those goods and services and the quantity of each that the economy should produce. It is a problem of allocation of scarce resources, which have alternative uses of resources among the various economic activities.

In a planned economic system, this problem is solved by a Central Planning Authority according to the social requirements. Based on the social requirements, the central planning authority determines what goods to produce and in what quantities.

How to produce?

How to produce refers to the choice of the combinations of factors and the particular technique/s used in producing goods and services. Since a good or service can normally be produced with different factor combinations and different techniques, a problem arises as to which of these techniques/s to use.

In a planned economic system, this problem is solved by a Central Planning Authority based on the availability of resources and the nature of the product.

Eg - The Central Planning Authority determines whether to use capital-intensive technology or labor-intensive technology.

To whom to produce?

To whom to produce refers to the determination of the distribution of national income among the factor owners of the economy.

In a planned economic system, this problem is solved by the Central Planning Authority. This is solved by taking into consideration the requirements of society. The final objective of the Central Planning Authority is to maximize the common welfare of the people.

(06 marks)

(a) Characteristics of Land as an economic resource

- It is a natural factor
- Comparatively, an inelastic supply exists
- Limitations/barriers in relation to the mobility
- Possibility of improving productivity.
- The income generated through the productive factors of land is the rent

(02 marks)

(c) The reason as to why Economics is considered as a social science

Economics is considered a social science because it examines human behavior in the context of resource allocation, production, consumption, and distribution of wealth. It examines how individuals, businesses, and governments make decisions affecting the welfare of society. Economics employs empirical research, data analysis, and mathematical models to comprehend and explain economic phenomena, as do other social sciences. In addition, it examines social issues such as poverty, inequality, and public policy, emphasizing its role in analyzing the broader effects of economic decisions on society.

(02 marks)
(Total 10 marks)

Suggested Answers to Question Three:

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

(a)

(i) $Q_d = 3300 - 8P$
 $Q_s = -1500 + 4P$

$Q_d = Q_s$; at the Equilibrium

$3300 - 8P = -1500 + 4P$

$4800 = 4P + 8P$

$4800 = 12P$

$400 = P$

Substituted for the Qd Equation

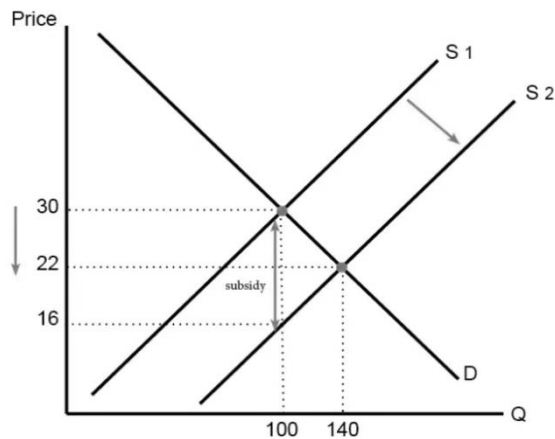
$Q_d = 3300 - 8P$
 $= 3300 - (8 \times 400)$
 $= 3300 - 3200$
 $= 100 \text{ (Units)}$

Substituted for the Qs Equation

$Q_s = -1500 + 4P$
Or $= -1500 + (4 \times 400)$
 $= -1500 + 1600$
 $= 100 \text{ (Units)}$

Equilibrium Price = Rs.400

Equilibrium Quantity = 100 (Units)



(03 marks)

(ii) Producer's Surplus

Producer's Surplus = $\frac{(\text{Equilibrium Price} - \text{Minimum Price}) * \text{Equilibrium Quantity}}$

2

$$= \frac{(400 - 0) * 100}{2}$$

2

$$= \underline{\underline{\text{Rs. 20,000/-}}}$$

(02 marks)

(b) The consequences of the provision of a unit subsidy by the government to producers on an agricultural product

Providing of subsidies to consumers and producers can be considered as another method of government intervention in the free market. A payment made to producers by the government with a view to increasing production by minimizing the cost of production is referred to as the production subsidy. Therefore the quantity provided by producers is high. As a result, the supply curve shifts to the right. It also changes the market equilibrium position, which is determined through the free interaction of demand and supply forces.

(05 marks)

(Total 10 Marks)

Suggested Answers to Question Four:

Chapter 05 - Financial System, Money, and General Price Level

(a) Reasons for the present inflationary situation in Sri Lanka

(Mentioning any two of below mentioned reasons would permit full marks.)

- Political Instability resulting in currency depreciation
- Increase in price of Crude oil in global markets.
- Establishing economic policies without investigating the country's situation properly.
- Depreciation of the Sri Lankan Rupee against USD (Depreciation of Exchange Rate).
- Severe drop of Foreign reserves in Central Bank of Sri Lanka.
- Non-establishment of strategies to boost foreign trade.

(02 marks)

(b) Remedies to reduce the present inflationary situation in Sri Lanka

(Explaining any two of below mentioned remedies would permit full marks.)

- **Increase taxes to curb spending**

Government can increase taxes through the fiscal policy to curb / cut down on spending.

- **Encourage producers to increase production**

Increasing output can meet rising demand, helping stabilize prices by preventing shortages.

- **Adopt strategies to accelerate the growth in aggregate supply**

Expanding the economy's productive capacity can ease inflationary pressures.

- **Adopt strategies to limit/slow down the growth in aggregate demand**

Reducing excessive spending can curb demand-driven inflation.

- **Remove barriers in the efficient distribution of resources**

Efficient allocation can prevent bottlenecks and price hikes.

- **Introduce credit control mechanisms**

Restricting access to credit can reduce excess spending and demand.

Eg: Increasing interest rates so that borrowings will be more expensive, this would result in reduced spending

- **Encourage Savings**

Mechanisms to encourage Savings so would result in reduced spending.

Eg: Increasing interest rates to attract savings

- **Introduce price control mechanisms**

Temporarily capping prices on essential goods can mitigate inflation.

- **Stabilize exchange rates and minimize trade and Balance of Payment deficits**

A stable currency and trade surplus can prevent imported inflation.

- **Minimize imports and increase export income**

Reducing imports and boosting exports can improve trade balances and limit inflationary pressures.

(04 marks)

(c) Implications of monetary policy on Sri Lankan businesses

The Central Bank of Sri Lanka, which oversees monetary policy, has a direct impact on businesses in a number of ways.

Businesses suffer greater borrowing costs when the Central Bank tightens monetary policy by raising interest rates (Increasing cost of borrowing), which can lower investments in expansion and employment creation. This can result in slower economic expansion and lower sales for businesses.

On the other hand, a loosening of monetary policy, such as a reduction in interest rates, can encourage consumer and business investment, thus increasing economic activity. Also this will increase the demand for goods and services in the economy due to increased money supply. Moreover, savings will be discouraged since the return is comparatively low.

Additionally, the cost of imported inputs and the competitiveness of exports, which is crucial for a variety of industries dependent on international trade, can be affected by exchange rate policies, which can have an effect on businesses.

(04 marks)

(Total 10 marks)

Suggested Answers to Question Five:

Chapter 06 - International Trade and Foreign Exchange Market

**(a) Items that are included in the financial account of the balance of payment statement.
(Explaining any two of below mentioned items would permit full marks)**

- Foreign Direct Investment
- Portfolio Investment
- Financial Derivatives
- Long-term and short-term government loans
- Receipts of Privatization
- Private long-term and short-term loans and liabilities
- Foreign reserve assets
- Assets of Commercial banks

(02 marks)

**(b) (Identifying any two of the arguments mentioned below supporting and opposing
Protectionism would permit full marks)**

Arguments for Protectionism

- 1 The importance in the national security
- 2 Employment – Workers would become unemployed in industries that cannot compete with cheaper imports. Thus, tariffs are imposed to keep out the “cheaper” imports.
- 3 Increase the utilization of domestic resources.
- 4 Key Industries – Some industries, for example, Iron, steel, agriculture, and scientific instruments, are regarded as strategic industries that are essential in the event of crises. Such industries needed protection to reduce a country’s dependence on imports of strategic materials.
- 5 Diversification of Industry – A country should not depend on one or a few industries because this could lead to mass unemployment if foreign demand falls. In order to minimize these risks in order to produce a variety of goods, protection is accorded to them.
- 6 Helps to bring out solutions for Balance of Payments difficulties.

Arguments against Protectionism

- 1 Market Distortion and loss of economic efficiency – Protectionism can be an ineffective and costly means of sustaining jobs and supporting domestic economic growth.
- 2 Higher prices for consumers – Import tariffs, in particular, push up prices for consumers and protect inefficient domestic sectors from genuine competition. They penalize foreign producers and encourage an inefficient allocation of resources both domestically and globally.
- 3 Reduction in market access for producers
- 4 Export subsidies depress world prices and damage output, profits, investments, and jobs in many lower and middle-income developing countries that rely heavily on exporting primary and manufactured goods for their growth.
- 5 Extra costs for exporters – For goods that are produced globally, high tariffs and other barriers on imports act as a tax on exports, damaging economies and jobs, rather than protecting them.
- 6 Adverse effect on poverty – Higher prices from tariffs tend to hit those on lower incomes hardest because the tariffs fall on products that lower-income families spend a higher share of their income. Tariffs can, therefore, lead to a rise in relative poverty.
- 7 Retaliation and trade wars – There is a danger that one country imposing import controls will lead to retaliatory action by another.

(05 marks)

(c) Economic effects of the devaluation of the Sri Lankan Rupee against the US Dollar

(Explaining any two of the below mentioned effects would permit full marks.)

- **Prices on imports will increase** – There is a disadvantage to importers due to the increase in price with the devaluation of the rupee against the US Dollar. Therefore, they have to pay more for imports, and ultimately, the burden passes to the customer. As a result, the prices of goods available in the market will increase.
- **Revenue on export will increase** – When the rupee depreciates against the US\$, makes exports more competitive and cheaper for foreign buyers. This will increase the demand for exports, and income from exports will increase.

- **Increase in inflation** – Due to the devaluation of the rupee against the US Dollar, it will result in an increase in inflation since prices of raw materials and consumer goods increase.
- **Deficit in balance of payment account**
Sri Lanka's export revenue is less than imports. When prices of imported goods are increased, it affects in increasing the deficit of the balance of the payment account. Therefore, the government needs to obtain more borrowings to settle the deficit of the balance of the account.
- **The government has to pay more as interest on foreign loans**
If the rupee value is devalued, the government has to pay more as capital repayment and loan interest on foreign borrowings. As a result, the government has to reduce capital investment and should take more borrowings to settle the loans and interest.
- **Reducing foreign direct investment**
Foreign investors will be discouraged to invest in Sri Lanka due to the devaluation of the rupee. Direct investment is the main factor for the economic development of the government.

(04 marks)

(Total 10 marks)

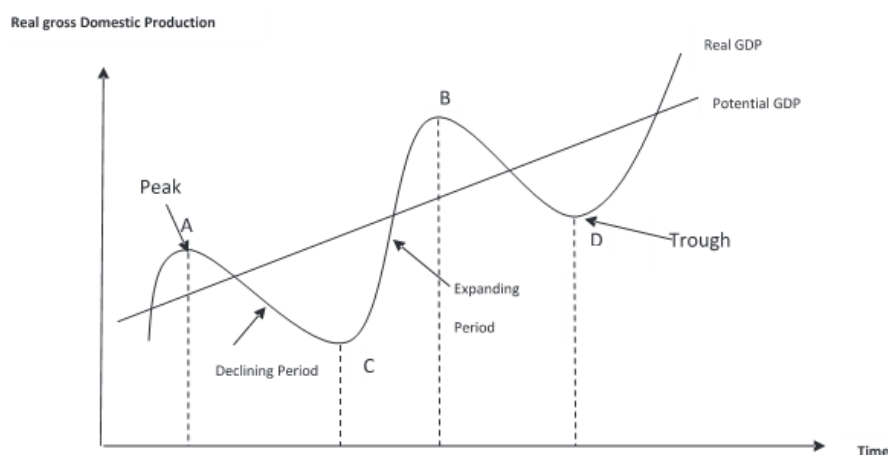
End of Section B

Suggested Answers to Question Six:

Chapter 04 - National Accounting and Role of the Government

(A) The different phases in the business cycle

The business cycle represents the recurring pattern of economic growth and contraction in an economy. It typically consists of four phases as illustrated below:



Expansion (Recovery): This phase marks the period of economic growth following a trough (the previous low point in the business cycle). During an expansion, key economic indicators, such as GDP, employment, and consumer spending, rise. Businesses experience increased demand for goods and services, leading to higher production and investment. Confidence and optimism prevail in this phase.

Peak: The peak is the highest point of the business cycle, where economic activity reaches its maximum level. It's characterized by robust GDP growth, low unemployment, and high levels of consumer and business confidence. Inflationary pressures may start to build as demand outpaces supply. At the peak, the economy is operating near its full potential.

Contraction (Recession or Downturn): After the peak, the economy enters a period of decline known as a contraction or recession. Economic activity contracts, leading to a decrease in GDP, rising unemployment, and reduced consumer and business confidence. Investment and consumer spending decline, and businesses may cut production and lay off workers to cope

with reduced demand.

Trough: The trough represents the lowest point of the business cycle. It's characterized by minimal economic activity, high unemployment, and depressed consumer and business sentiment. However, it also marks the turning point where the economy begins to recover and move into the expansion phase again.

(04 marks)

(B)

(a) Gross Value Added (GVA) at basic price.

Item	Rs. millions
Compensation of Employees	4,200
Gross Operating Surplus	3,600
Mixed Income	1,800
Other taxes less subsidies on production	600
Gross Value Added (GVA) at basic price	10,200

(05 marks)

(b) Gross Domestic Product (GDP) at market price

Item	Rs. millions
Gross Value Added (GVA) at basic price	10,200
Net taxes on production and Imports	700
Gross Domestic Product (GDP) at market price	10,900

(02 marks)

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

Item	Rs. millions
Gross Domestic Product (GDP) at market price	10,900
Net Foreign Primary Income	300
Gross National Income (GNI) at market price	11,200

(02 marks)

(C) Main sectors of the macro economy that contribute to the economic process.

- Household Sector
- Business Sector
- Government Sector
- Foreign Sector

(03 marks)

(D) Difference between “Contractionary Fiscal Policy” and “Expansionary Fiscal Policy”.

"Contractionary Fiscal Policy" and "Expansionary Fiscal Policy" are two contrasting approaches governments use to influence an economy's overall health, particularly during economic downturns or inflationary periods.

The primary goal of **Contractionary Fiscal Policy** is to cool down an overheated economy and combat inflation. It involves reducing government spending and/or increasing taxes to decrease aggregate demand.

The primary goal of **Expansionary Fiscal Policy** is to stimulate economic activity and boost growth during a recession or economic downturn. It involves increasing government spending and/or reducing taxes to increase aggregate demand. This can lead to slower economic growth and reduced government services but may help maintain price stability.

(04 marks)

(Total 20 marks)

End of Section C

Notice:

These answers compiled and issued by the Education and Training Division of AAT Sri Lanka constitute part and parcel of material for AAT students.

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

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