Association of Accounting Technicians of Sri Lanka

Level I Examination – July 2024

Suggested Answers

(103) ECONOMICS (ECN)

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A publication of the Education and Training Division

THE ASSOCIATION OF ACCOUNTING TECHNICIANS OF SRI LANKA

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(103) ECONOMICS

SUGGESTED ANSWERS

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

Suggested Answers to Question One:

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

1.15 Expect only two ways

- Imposition of taxes.
- Providence of subsidies.
- Introduction of price controls.
  - Introduction of maximum legal price.
  - Introduction of minimum legal price.
- Stabilization of price.

1.16 Expect only differences

Needs	Wants
Needs are common to all,	Wants differ from person to person.
Needs are Limited	Wants are Unlimited
Needs are Primary	Wants are Secondary
It is a must that these are fulfilled	Not a must to fulfill them.
Needs Cannot be influenced through advertising	Wants Can be influenced through advertising

1.17

Credit rating refers to the rating of the financial instruments on the basis of qualitative aspects and it assesses the ability of borrowers to repay their debt. To do this, these agencies issue credit ratings based on the borrower's solvency. The biggest credit rating agencies are

- Standard and Poor's (S&P),
- Moody's
- Fitch Ratings.

1.18 Expect two Characteristics of Oligopoly Markets

- Only a few firms operate in the entire market.
- Existence of entry/exit barriers.
- Existence of interdependence among the firms in the industry.
- Producing of either differentiated or homogeneous products
- The firms in Oligopoly market face relatively inelastic
- downward slopping demand curve

1.19 Expect only two Financial intermediaries

- Licensed commercial banks
- Licensed special banks
- Cooperative societies
- Registered financial institutions
- Insurance organizations
- Leasing companies
- Unit trusts investment companies
- Employees Provident Fund

1.20 Expect only two Social profiles of Sustainable Development

- Corporation.
- Justice.
- Social coexistence.
- Empowerment.
- Cultural integrity.
- Social mobility

(02 marks each, Total 40 marks)

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End of Section A

Total 40 Marks **SECTION - B**

Suggested Answers to Question Two:

Chapter 01: Economic Concepts and Systems related to Business Environment

(a) Expect only two Characteristics of Economic Goods

- Existence of limitation/scarcity in supply.
- Existence of cost of resources.
- Existence of opportunity cost.
- Most of the economic goods are having a price.
- Economic goods are an outcome of a production process.
- Existence of a clear ownership

(03 marks)

(b)

What to produce?

In a mixed economic system in answering the said questions the private sector is driven by the profit motive, it produces the goods and services that can attract a price, and also on which a profit can be made. However, the public sector produces goods and services with the intention of providing social welfare.

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How to produce?

Under mixed economic system the private sector may use techniques with minimum cost that maximize its profitability whereas the state may employ techniques that could maximize social welfare and equity of the society.

To whom to produce?

It is the purchasing power of the private sector that determines the answer to the question "to whom to produce?" under mixed economic system. Also, the public sector solves this problem based on the social need.

(05 marks)

(c) Expect only one reason

The reasons for the inverse relationship between price and quantity demanded are given below.

1. Substitution effect of a price change
2. Income effect of a price change

Substitution effect of a price change

When other factors remain constant including the price of substitute goods, due to increase or decrease of the price of concerned goods (Given that all the other factors that influence the demand for remain constant), change of quantity demand of the considering good as a result of increase or decrease in relative price of the good is known as substitute effect

Income effect of a price change

When other factors remain constant including the nominal income of consumers, changes of the quantity demanded according to the change in purchasing power due to changes of real income is called income effect.

(02 marks)
(Total 10 marks)

Suggested Answers to Question Three:

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

(a)

$$Qd = 1200 - 20p$$
$$Qs = -200 + 20p$$

$$Qd = Qs$$
$$1200 - 20\,p \;= -200 + 20\,p$$
$$-20p - 20p \;\; = -200 - 1200$$

$$\frac{-40p}{-40} = \frac{-1400}{-40}$$

p = Rs. 35

By substituting p = 25 to the demand equation

$$Qd = 1200 - 20p$$
$$Qd = 1200 - 20\,X\,35$$
$$Qd = 1200 - 700$$

500 units

(03 marks)

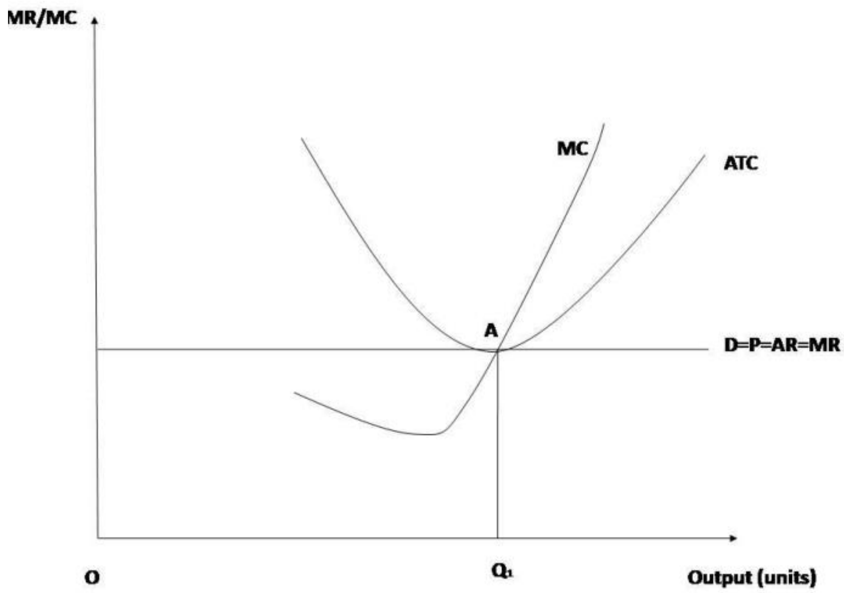
(b) Expect only three factors

- Whether the relevant good is a necessity or luxury.
- The number of substitutes available and their closeness to the given item.
- The percentage of income spent on the good.
- The number of alternative usages of the given good.
- The time period; the time period necessary to adapt to the change in price

(03 marks)

(c)

A perfectly competitive firm maximizes profits in the short run by producing the quantity where MC = MR, selling that quantity at the market price, and earning economic profits if price exceeds the minimum point on the ATC curve. The firm will shut down if price falls below AVC in the short run. Below illustrated is how to determine the profit-maximizing quantity and price using a graph.



(04 marks)

(Total 10 Marks)

Suggested Answers to Question Four:

Chapter 05: Financial System, Money and General Price Level

(a) Expect only two motives

- Transaction Motive
- Precautionary motive
- Speculative motive

(02 marks)

(b)

Commercial banks face a balancing act between profitability and liquidity.

- Liquidity Objective: To maintain public confidence, banks need sufficient liquid assets to meet customer demands, but these assets typically generate lower returns.
- Profitability Objective: Banks must also generate profits by extending credit and investing in long-term assets, which are less liquid but offer higher returns.
- The challenge is to balance these objectives—focusing too much on profitability can reduce liquidity, while prioritizing liquidity may limit profit opportunities. Maintaining this balance is essential for a bank's stability and success

(04 marks)

(c) Expect only two qualitative monetary policies

- **Setting a maximum maturity period for loans**

By reducing the maximum loan repayment period, it will reduce the flow of loan quantity. When the repayment period is increased, it will increase the loan for some sector. Therefore, when there is a need to encourage some sector of the economy then the repayment period of loan has to be increased

- **Setting preferential rates of interest**

If there is a need to reduce the flow of loans to one section, then the rate of interest is increased and vice versa. If there is a need to increase the flow of loan to one section the guarantees needed to secure loans are reduced for that sector and vice versa.

- **Setting limits for investments and loans**

If there is a need to increase the flow of loan to one section the guarantees needed to secure loans are reduced for that sector and vice versa.

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- **Setting Limits for loan guarantees**

This implies setting limits for the loans supplied to a particular section. If this limit is decreased then the flow of loans to that sector is increased and vice versa.

- **Others**

Also, setting limits on Letters of Credit and maintaining cash balances. Indirect controls, such as moral suasion, are also employed to influence lending practices and financial stability.

(04 marks)
(Total 10 marks)

Suggested Answers to Question Five:

Chapter 06: International Trade and Foreign Exchange Market

(a) Expect only two assumptions

- Perfect mobility of resources
- Constant returns to scale
- Zero transaction cost
- There are no externalities in the production or consumption

(02 marks)

(b)
(i)
Country A has the absolute advantage of producing Product Q

Country B has the absolute advantage of producing Product P

(02 marks)

(ii)

Product / Country	P (in units)	Q (in units)
A	4	12
B	21	7

In order to determine the comparative advantage, the opportunity cost of production of each product should be calculated.

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Country	The opportunity cost of producing Product P	The opportunity cost of producing Product Q
A	12/ 4 = 3	04/12 = 0.33
B	7/21 = 0.33	21 / 7 = 3

According to the table given above country A has the lowest opportunity cost of producing product Q and country B has the lowest opportunity cost of producing product A. So

- Country A has the comparative advantage of producing Product Q (0.33< 3)
- Country B has the comparative advantage of producing Product P (0.33 < 3)

(04 marks)

(c) Expect only steps

- Increase the competitiveness of exports
- Take necessary measures to reduce the import expenditure
- Take necessary measures to reduce the external imbalances, in the same way which reduce the internal imbalances with the utilization of domestic resources.
- Allow the monetary policy to operate freely without any intervention.

(02 marks)
(Total 10 marks)

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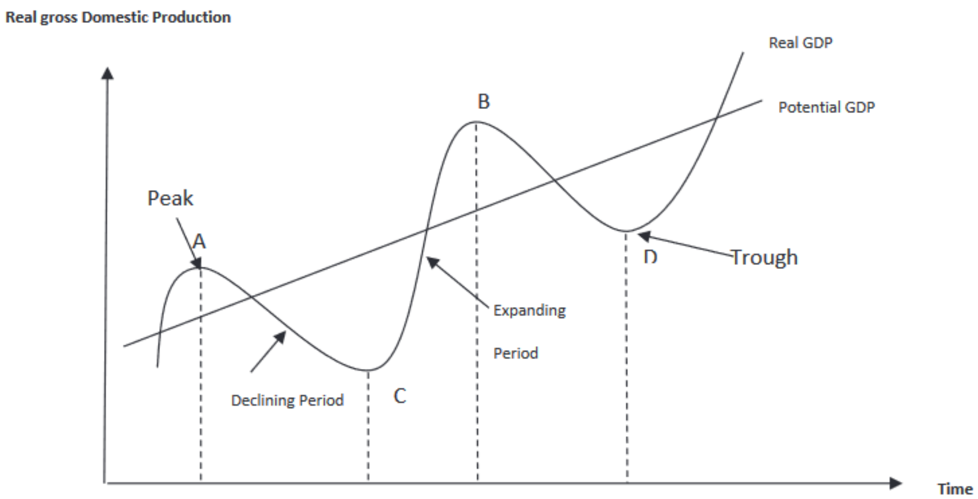
End of Section B

Suggested Answers to Question Six:

(A)

(a)



Explaining any two phases in the Trade (business) Cycle would permit full marks

There are four phases in the business cycles.

1. Peak - The peak is known as the highest point of the line. The economic expansion ends and the downturn begins at this point.
2. Declining stage - The period in which the GDP declines is considered to be a recession or declining stage. The production and employment decline in this period.
3. Trough - The economic downturn ends and the expansion phase begins at a time known as the trough. This is the lowest point.
4. Expanding Stage - The period from the trough to the peak of the economic process is known as the expansion phase.

(03 marks)

(B) (a)

	Item			Rs. million
1.	Private consumption expenditure		=	1,600
2.	Government consumption expenditure		=	2,500
3.	Gross domestic capital formation		=	9,550
	3.1 Gross domestic fixed capital formation 4,500			
	3.2 Changers in stock 2,500			
	3.3 Changes in values 2,550			
	Gross Domestic Expenditure (GDE) at market price	**1 + 2 + 3**	**=**	**13,650**

(06 marks)

(b)

	Item		Rs. million
1.	Gross domestic expenditure(GDE)	=	13,650
2.	Add: Export of goods and services	=	4,800
	Less : Import of good and services	=	(2,750)
	Gross Domestic Product (GDP) at market price	=	**15,700**

(03 marks)

(c)

	Item		Rs. million
1.	Gross domestic product (GDP) at market price	=	15,700
2.	Foreign net primary income	=	1,004
	Gross National Income (GNI) at market price	=	**16,704**

(02 marks)

(C) The difference between Gross Domestic Income (GDI) and Gross National Income (GNI) is Net primary income from rest of the world.

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Gross National Income = Gross Domestic Income + Net primary income from rest of the world.

All the primary incomes of an economy is identified as the Gross Domestic Income. Gross National income means the income generated from goods and services produced by the nation and the difference of income generated by domestic residents from their factors of production invested abroad and payments made to foreigners for investing their factors of production domestically is taken into account when compiling Gross National Income of a country.

(03 marks)

(d)

- Business will see more investment opportunities related to government spending. This commonly occurs during the expansionary fiscal policy when more money is following in to the economy from the government and from other sources. Since taxation is also low. When balance between price and demand is met then companies can expect to thrive and grow.
- On the other hand, contactionary fiscal policy calls for higher taxes and reducing spending. This has a direct impact on a business's bottom line.
- The government will have to resort to borrowing when its revenue is not sufficient to cover its expenditure and this could have upward pressure on the interest rate of the economy. Higher rate of interest discourages investments and what this implies is that higher government expenditure leads to crowd out private investment.
- Businesses face several taxation. Fiscal policy also impacts the amount of taxation on future generations. Government spending that leads to greater difficulties mean taxation will eventually have to increase to pay interest. It impact to the business.

(03 marks)

(Total 20 marks)

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End of Section C

Notice:

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