



G.C.E. A/L Examination March - 2020

Conducted by Field Work Centre, Thondaimanaru
In Collaboration with

Provincial Department of Education Northern Province

Grade :- 13 (2020)

Economics

Marking Scheme

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

50X1 =50 Marks

PART II
Sub-section A

01. 1.1. Determine which statements are normative statements, positive statements from the following statements belongs to

- | | |
|--|------------------------|
| a. It should increase monthly salary of every government worker by Rs.5000 | -normative statements |
| b. Positive relationship exists between money supply and the price level. | - positive statements |
| c. Population growth rate in Sri Lanka is 1% | - positive statements |
| d. Sri Lanka should obtain foreign aids for development | - normative statements |
- (4X1=4marks)**

2. a. Define the term opportunity cost?

When selecting one alternative from all other alternatives available, the value of the next best alternative forgone is called opportunity cost. (1Mark)
Opportunity cost is also named as real cost and as economic cost. (1Mark)

b. What is the law of increasing opportunity cost?

the full employment economy, increasing the fixed amount of a certain goods the situation of increasing the amount of forgone good is identified as increasing opportunity cost. (2Marks)

3. a. What is meant by “Non economics resources”? (2marks)

The non scarce resources gifted by nature and which do not involve an opportunity cost are called non economic (1Mark)
Example :- sun light, air, rain water (1Mark)

b. What are the main characteristics of economics resources”?

- * involve an opportunity cost
 - * scarce resources
 - * alternative resources
- (2x1 = 2marks)

4. What conditions must be satisfied if resources are used efficiently in an economy?

Production efficiency means achieving of maximum output from all resources of an economy. This can be shown by any point on the Production Possibility Frontier. Two main conditions are necessary for the production efficiency. They are full employment and full production. (1Mark)

- Allocative efficiency means distribution of limited resources of an economy based on society’s preference. Condition for this is Price = Marginal cost(P=MC) or Marginal Cost = Marginal Revenue (MC=MR). Allocative efficiency can be shown by only one point on the Production Possibility Frontier. (1Mark)
- The benefit gain by the consumption of an additional unit of a particular goods is known as marginal benefit It would be the maximum price that the consumer is willing to pay for the good. Therefore marginal benefit will be equal to price. The amount added to the total cost When increasing the output of a particular good by one unit is called marginal cost(MC). (1Mark)
- The sum of allocative efficiency and productive efficiency is known as economic efficiency. (1Mark)

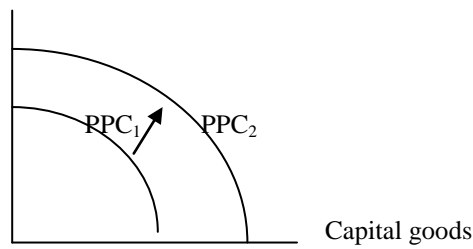
5. a. What are the assumptions for given production possibilities curve?

- Production of only two goods
 - Resource stock remains constant
 - Technology remains constant during the concerned period
 - Fully utilization of resources with maximum efficiency
- (4 X ½ =2marks)**

b. Draw production possibilities curve that shows increasing opportunity cost. Also show the following on different production possibilities curve

i. increasing in Resources endowment

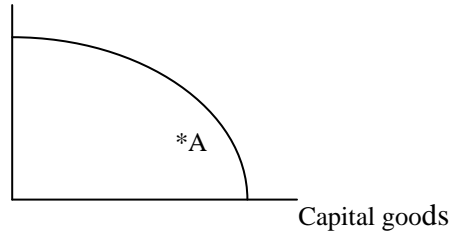
Consumer goods



(1Mark)

ii. Underemployment of Resources

Consumer goods



(1Mark)

02. **1. a. Explain the Law of demand?**

(2marks)

In a certain period of time, when other factors affecting demand remains constant the inverse relationship between price and the quantity demand of goods, is called the law of demand. (1mark)

In a certain period of time, when other factors affecting demand remains constant if the price increase the quantity demand decrease. and the price decrease the quantity demand increase. (1mark)

b. What are the assumptions of Law of Demand?

(2marks)

- Considers price and quantity demanded at a certain time period
- Other factors affecting demand remain constant except the price
- Considers demand of a normal good
- Considers behavior of rational buyers

(4X1 = 2marks)

2. a. Distinguish between individual demand and market demand?

(2marks)

- * At a certain period of time, , the various quantities ready to buy by a person at various prices of good is individual demand. (1mark)
- At a certain period of time, the various quantities ready to buy by sum of all individuals at various prices of good is called as market demand. (1mark)

b. what factors influence the market demand for a normal good?

(2marks)

- Price of the concerned goods(P)
- Price of the related goods(Pn)
- Consumer Income(Y)
- Consumers' Taste (T)
- Future expectations (Ex)
- Number of buyers and the composition (N)

(4 X ½ -2marks)

3. Market demand curve and the market supply curve for sugar have been given below

P	Qd (million)	Qs(million)
100	1.0	0.5
200	0.5	1.0

When the price increasing Rs 100 to Rs 200

a. calculate change in consumer expenditure ?

(2marks)

P	Qd (million)	CE=PXQd	
100	1.0	100	
200	0.5	100	(1 mark)
change in consumer expenditure = 100-100 =0 (Zero)			(1 mark)

b. discuss about elasticity of demand according consumer expenditure method ? (2marks)

Unitary elastic demand (1mark)

Price Increase Rs 100 -200 consumer expenditure Constant in RS 100 (1mark)

4. State four Reasons for shift of the supply curve and briefly explain these factors (4marks)

*change in Price of inputs (C)

* change in Technology (T)

* change in Prices of related goods (Pn)

* change in Expectations of producers (Ex)

* change in Government Policies (G)

(change in must be in the answer 4x1=4marks)

(factors only 2marks for 4 answer)

5. Explain the factors that determine the elasticity of supply? (4marks)

*. Factor mobility of production

*. Nature of the good

*. Availability of storage facilities

*. Time that take to (Change) adjust the supply

Moving that factors of production from one production process to another production process is called factors mobility of production. In the way, the resources shift from one production to another easily and also when price increase supply increase during a short period of time.

- Accordingly, when there is more factors mobility elasticity of supply is elastic supply.If the factors have immobility supply elasticity is inelastic supply.
- If the production factors have more substitution possibility to substitute the factors which use for a certain good to another product, that product has an elastic supply.
- Ex – the resources which for produce tables can be also use for production of beds because of this when increase the price of bed the resources use for table can be use for beds and bed supply will be increased
- If can be follow on more storage the rejoices that good has elasticity supply But if there is lack of storage facilities that goods have inelastic supply.
- If time is that good has elastic supply, If the time is short run that good has inelastic supply

(4 X 1 =4marks) or (2 factors with explain 4marks)

03. 1. Market demand curve and the market supply curve for sugar have been given below

$$Q_d = 500 - 10p \quad Q_s = -100 + 20p$$

Assume that the government now imposes a unit tax Rs.3

a. what is the equilibrium price and quantity after tax? (4marks)

$$Q_d = Q_{sT}$$

$$500 - 10p = -100 + 20p \quad (1 \text{ mark})$$

$$600 = 30p$$

$$p = 20$$

$$EP = 20 \quad (1 \text{ mark})$$

$$\begin{aligned} Q_{sT} &= -100 + 20(p-t) \\ &= -100 + 20(p-3) \\ &= -100 + 20p - 60 \\ &= -160 + 20p \quad (1 \text{ mark}) \end{aligned}$$

$$Q_d = 500 - (10 \times 20)$$

$$= 500 - 200$$

$$= 300 \text{ units}$$

$$EQ = 300 \text{ units} \quad (1 \text{ mark})$$

b. what is the government revenue from the tax? (2marks)

$$\begin{aligned} \text{government revenue} &= \text{unit tax} \times \text{EQ}(n) \\ &= 3 \times 280 \\ &= \text{RS } 840 \end{aligned}$$

c. what is the price elasticity of demand at new equilibrium? (2marks)

$$\begin{aligned} \text{Ped} &= b \times \frac{P}{Q_d} && (1 \text{ mark}) \\ &= -10 \times \frac{22}{280} \\ &= -0.78 && (1 \text{ mark}) \end{aligned}$$

d. calculate producer surplus after tax ? (4marks)

$$\begin{aligned} &\text{EQ}(n) \times \frac{(\text{PP}_{(\text{after tax})} - \text{MSP})}{2} && (1 \text{ mark}) \\ &= \frac{280 \times (19 - 5)}{2} && (2 \text{ marks}) \\ &= \text{Rs. } 1960 && (1 \text{ mark}) \end{aligned}$$

2.a. What are the approaches that can be taken to make maximum price meaningful.? (2marks)

There are several approaches that can be taken to make maximum price meaningful.

- *. Import
- *. Providing incentives for the producers
- *. Rationing

(2X1=2marks)

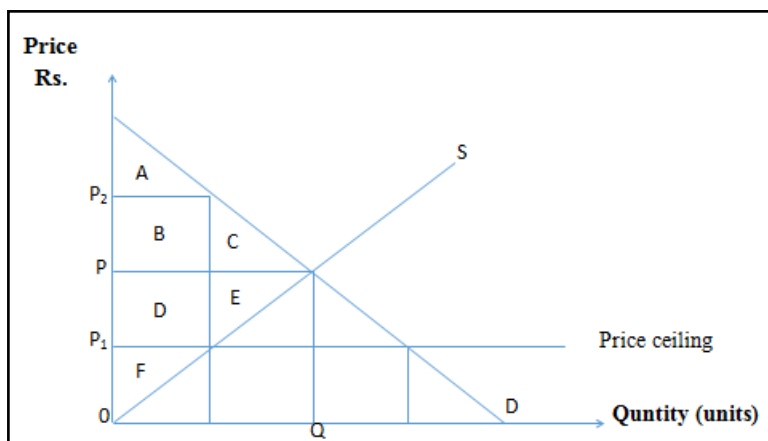
b. State two Non price rationing techniques As the price mechanism being neutralized due to the maximum price policy scare, goods have to be rationed by using non price rationing techniques.

Non price rationing techniques are as follows.

- Use of ration cards
- Queueing method
- Rationing with bribes
- Distribute connecting with other goods
- Black market price

(2X1=2marks)

3.



a. Economic surplus before maximum price ceiling A+B+C+D+E+F (1mark)

b. Economic surplus after price ceiling A + F (1mark)

c. Dead weight loss C + E (1mark)

d. what are the Two factors determine the inclusion of B + D to the consumer surplus in price ceiling

*. Money and time spent to purchase scare goods

*. Time spent at the queue.

(1mark)

04. 1. Explain the short run production function and long run production function (4marks)

Remaining technology and capacity of a firm constant the technical relationship between input and output following a change in variable inputs is called a short run production function. (1mark)

Which means, $Q = f(L, \bar{K})$ or $Q = f(V_1, V_2, V_3, \dots, V_n, K)$ (1mark)

The relationship between inputs and output of a production process following a change in all relevant inputs is called a long run production function. It can be shown as follows. (1mark)

$Q = f(V_1, V_2, V_3, \dots, V_n, K_1, K_2, K_3, \dots, K_n)$ (1mark)

2. a. Explain the diminishing marginal returns? (2marks)

In short run when increasing only variable inputs mixed with fixed inputs, the decrease in marginal product and average product of the variable factor after a certain point is called The Law of Diminishing Marginal Returns.

b. what are the assumptions of law of diminishing marginal returns relevant to short run output?

All variable inputs are homogeneous

Within the relevant production process technology remains constant (2marks)

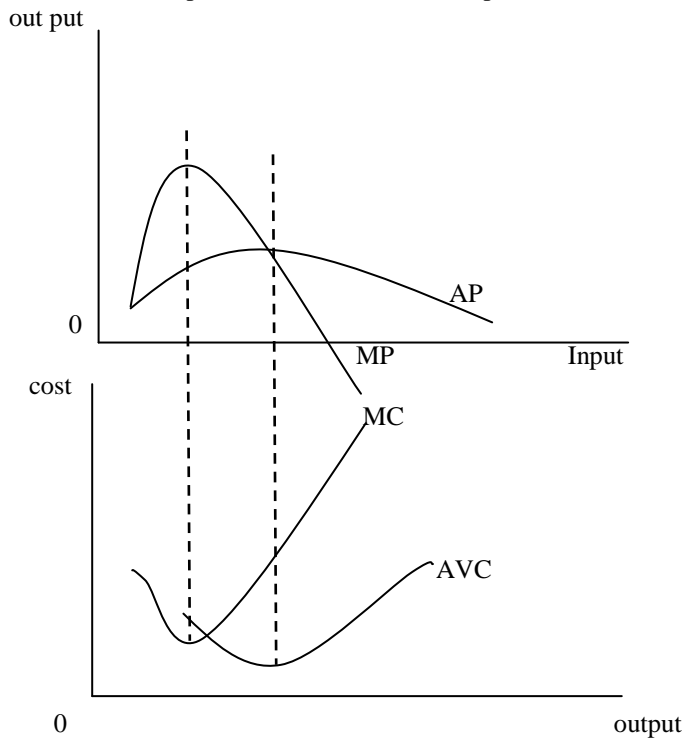
3. Which are the following cost effect in short run marginal cost briefly explain

- | | | |
|---------------------------|--------|----------------------|
| a. Cost depreciation | no | } (4 X 1/2 = 2marks) |
| b. material cost | effect | |
| c. Property tax | no | |
| d. Insurance installments | no | |

a,c,d are fixed cost in short run b variable cost so b only effect in short run marginal cost (2marks)

4. how to affect the short run Average product ,marginal product with short run cost curve (4marks)

A relationships between cost curves and product curves are shown by the diagram below,



According to the above graph,

- MC is minimized when MP is maximized
- AVC is minimized when AP maximized
- MP Curve goes down ward of an increasing rate by crossing the maximum point of the AP curve

5. a. state two factors affect the various market structures? (2marks)

- Number of firms in the market
- Homogeneity of the product
- Ability to enter the market and exit from the market
- The nature of the competition among the firms in the market.

(2 X1 = 2marks)

b. state two characteristics of perfect competition ? (2marks)

- Homogenous products
 - Large number of sellers and buyers
 - A Firm is a price taker
 - Free Entrance and Exit
 - There is perfect information
 - There are no barriers to mobility of factors
 - Obtained only normal profit in long runs by all firms at the market.

(2 X1 = 2marks)

1. Explain the macro economic objectives and state some Macroeconomic objectives (4marks)

Various objectives expected to be achieved through aggregate economic activities of a society are identified as macroeconomic objectives. (2 marks)

- Macroeconomic objectives are as follows.
- Full employment
- Economic stability
- Equity
- Economic growth
- Sustainable development

(2 X1 = 2marks)

2. Explain the Main duties of the government sector in a economy activity? (4marks)

- From the tax revenue they gain, provision of public goods, welfare goods and services.
- Protect national defense, law and peace. Protect environment. Provide social overhead capital such as education and health.
- Supply of economic overhead capital such as highways and communication.
- Providing of consumer subsidies to households and providing of producer subsidies to the business sector.

(4 X1 = 4 marks)

3. Compensation of employees	10000
Net operational surplus	12500
Fixed capital formation	2500
Mixed income	15000
other taxes on products minus subsidies	2000
Net taxes on products and imports	1000

Calculate :

a. Total value added at basic price

• Compensation of employees	10000
Net operational surplus	12500
Fixed capital formation	2500
Mixed income	15000
other taxes on products minus subsidies	<u>2000</u>
	<u>42000</u> (2marks)

b. Gross Domestic Product at market price (2X2=4marks)

Total value added at basic price + Net taxes on products and imports **42000 + 1000 = 43000**
(2marks)

4. state two examples for each
- a. Incomes not received by households
 - b. Incomes of households not included in national income (2X2=4marks)

Incomes not received by households

- Capital consumption
- Retained profits
- Corporate profits
- Contributions towards social protection
- Government's property income (2X1=2marks)

• Incomes of households not included in national income

- Net personal secondary income from rest of the world
- Pensions
- Interest gained by households for public debt
- Other subsidies gained by households (2X1=2marks)

5. Consumption function (C) = 600 + 0.8 Yd

Investment expenditure (I) = 200

Government purchases (G) = 300

Net Exports (X-M) = - 100

Autonomous Taxes = 250

Autonomous Taxes and Government purchases increasing 100 at the same time

- a. Explain if the national income change? (2marks)
yes increasing by 100 (1mark) reason: budget multiplier effect (1mark)
- b. Explain if the budget balance change? (2marks)
before $BB = T - G = 250 - 300 = -50$ (1mark)
after $BB = T - G = 350 - 400 = -50$ so no change (1mark)

Sub-section B

07. 1. What is the difference between "near money" and "money Subsidy"? (4marks)

The highly liquid assets which act as a store of value but which does not act as a medium of exchange are known as near money. Near money can be easily converted to medium of exchange (money). (1mark)

Examples : Fixed deposits, savings deposits, treasury bills, exchange bills, promissory notes.(1mark)

An instrument which act as a temporary medium of exchange and which does not act as a store of value is known as money substitutes. (1mark)

Examples : credit cards and debit cards (1mark)

Money substitutes can be used for short term transactions instead of money and cheques.

2. a. What is meant by "Demand for money"? (2marks)

The preference of the people to keep money in the form of money itself at a given period is known as demand for money or as liquidity preference (2marks)

- b. Why do people demand money? (2marks)

* Transaction motive

• Preactionary motive

- Speculative motive

(2X1=2marks)

3. What is meant by monetary base? how it relate with money supply? (4marks)

The direct financial liabilities which supply the basis for the aggregate money supply of a particular country is known as base money.

Base money also named as high powered money., and as reserve money.

The relationship between total money supply and base money is shown by the money multiplier. It can be shown by a equation as follows.

$$M = KH$$

M = Money supply

K = Money multiplier

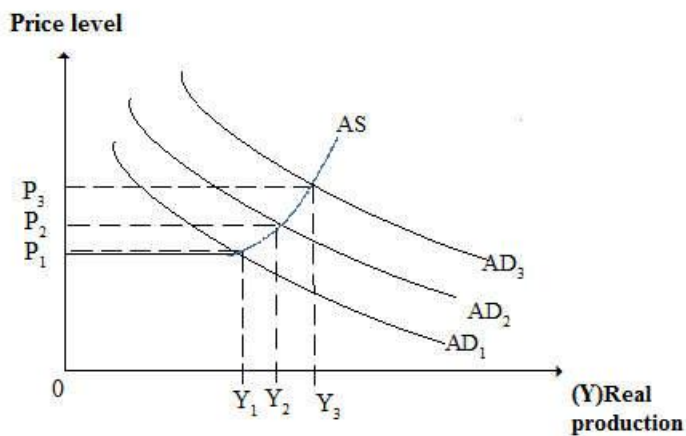
H = Base Money

4. Explain demand pull inflation with Keynesian theory? (4marks)

(4marks)

Keynesian theory use aggregate income and expenditure analysis to explain.

- After the economy reach to a macroeconomic equilibrium, if the aggregate demand increase the price level will beginning to increase because the supply can't be increased.
- The Keynesian approach of the inflation i. shown by the graph below.



According to the above graph Y1 shows the full employment level of output.

- The relevant aggregate demand is shown by AD1 curve.
- If the aggregate demand increase more than the full employment level of output of an economy the general price level increase as p1, p2 and p3 and generates demand pull inflation.

5. Suppose that statutory reserve ratio 20% and that the bank has reserves of Rs. 40 million ,loans and investments of Rs.160 million, and total Demand deposits of Rs.200 million.

a. Assume that this bank operates within a banking system. Can this bank expand its loans? Give reasons for you answer. (2marks)

$$\text{statutory reserve needed } 200 \times \frac{20}{100} = 40 \quad (1\text{mark})$$

$$\text{real reserve} = 40$$

so there is no excess reserve, this bank **Cannot** expand its loans (1mark)

b. what will be the increase or decrease in the quantum of bank lending if statutory reserve ratio is reduced to 15% (2marks)

$$\text{statutory reserve needed } 200 \times \frac{15}{100} = 30 \quad (1\text{mark})$$

$$\text{real reserve} = 40$$

so there is 10 excess reserve, this bank **Can** expand its loans (1mark)

07. 1. What is meant by market failure. What are the main effects for market failure? (4marks)

Inability of market mechanism to distribute scarce resources toward society's well being is called market failure. (1mark)

- Following reasons affect for market failure
 - * Inefficiency of resource allocation
 - * Macroeconomic instability
 - * In equal distribution of income

(3 X 1 = 3marks)

2. Define the global public goods, what features can be identified with related to a global public good. ? (4marks)

there are some other public goods which lie beyond geographical boundaries of a country. These are identified as global public goods. (1mark)

- Following features can be identified with related to a global public good.
 - * Non competition in consumption (non rivalry)
 - * Non possibility of limiting consumption for the people who do not pay (non excludability)
 - * Benefits of such goods can be gained by anyone who lives in the world.

(3 X 1 = 3marks)

3.a. What are the objectives of taxation? (2marks)

- * Minimize inequality in distribution of income and wealth
- Management of resources to improve efficiency
- Discouraging of the consumption of demerit goods which borne a high social cost
- Affect over aggregate demand
- Affect over aggregate supply

(2X1 = 2marks)

b. What are the two conditions should be fulfilled to achieve the tax principle of equity? (2marks)

Two conditions should be fulfilled to achieve the tax principle of equity.

- Horizontal equity
- Vertical equity

(2X1 = 2marks)

4. Item	Rs. in million
Total revenue and grants	170 000
Total revenue	165 000
Tax revenue	150 000
Non tax revenue	15 000
Grants	5 000
Expenditure and lending minus repayments	200 000
Recurrent Expenditure	175 000
interest payment	10 000
Capital and net lending	25 000
Public investment	20 000

According to above budget schedule calculate:

a. Balance of current account (2marks)

Total revenue without grants - Recurrent Expenditure (1 mark)

$$= (170\,000 - 5\,000) - 175\,000 = -10\,000$$

deficit 10000 (1 mark)

b. Balance of primary account (2marks)

Total revenue and grants – Total Expenditure and lending minus repayments without interest payment

(1 mark)

$$170\,000 - (200\,000 - 10\,000) = -20\,000$$

deficit 20000

(1 mark)

5. Define the term of Supply side policies and state Instruments of supply side policies (4marks)

Supply side policies are the microeconomic fiscal policies. The objective of supply side policy is to speed up economic growth through increase of economic efficiency in the market.

- When supply side policies are implemented productivity increases with increase in investment due to decrease in cost of production. Also supply side policies are used to direct main macroeconomic variables towards expected level (2marks)

Instruments of supply side policies :

- Tax reforms
- Privatization
- Deregulation
- Labour market reforms
- Capital market reforms (2 X1 = 2marks)

08. 1. what is competitive advantage? what are the sources of competitive advantage? (4marks)

Comparative advantage theory state that, if a particular country can produce a particular good with a relatively less opportunity cost than the other country, the country has comparative advantage is producing one good and if a particular country has relatively high opportunity cost than the other country then that country has no comparative disadvantage in producing that good. (1 mark)

- Comparative advantage theory state that, when countries engage in the international trade, they can export the good in which that have advantage and import the good in which they have comparative disadvantage. (1mark)

sources of competitive advantage

Cost advantage sources

- High levels of productivity
- High capacity utilization
- use of bargaining power to negotiate the lowest cost prices for production inputs
- Effective use of technology in the production process
- Access to most effective distributional channels

Differentiation sources

- Superior quality products.
- Branding
- Innovation
- Products and intellectual property
- Consistent promotional support

(2X 1 = 2marks)

2. What are the Approaches used for protection except import and export tariffs are called non tariff barriers (4marks)

non tariff barriers they are as follows.

- *. Imposing rationing or deciding a quota
- *. Providing subsidies or incentives for producers
- * Dumping
- * Limiting the exports voluntarily
- * Controlling the foreign exchange
- * Imposing rationing for limitation of export and imports
- * Imposing trade embargoes
- *. Imposing standards of administration and technological standards

(4 X1 = 4marks)

3. a. What is meant by Commodity terms of trade? (2marks)

The amount of units that can be imported from a unit of good exported is known as commodity terms of trade. (1mark)

- Commodity terms of trade can be calculated as follows.

$$\text{Commodity terms of trade} = \frac{\text{Export Price Index}}{\text{Import Price Index}} \times 100 \quad (1 \text{ mark})$$

b. Reasons for decrease in commodity Reasons for increase in commodity terms of trade (2marks)

- Increase in export price index while decrease in import price index .
- Decrease in export price index more than decrease in import price index.
- Increase in import price index while export price index remain constant .
- Decrease in export price index while import price index remain constant (2 X 1= 2marks)

4. Assume that the price of pair of shoe is Rs. 5 000 and Rs 3 000 spent to import inputs needed to produce this pair shoes Then the domestic value added of the good is Rs. 2000 (5 000 – 3000). Assume that same pair of shoe selling at the same price at the world market. Accordingly if the Domestic value added of the firm is more than to Rs. 2 000, then the price of domestic shoe will be more than Rs. 5 000, because of that domestic product cannot completion with the imported good. So, we think, to protect the domestic producer if a tariff as of 10% is imposed on imported production. Then price of imported good changed as below. Accordingly effective rate of protection

The price of pair of shoes before tariff = 5 000

The cost for the tariff = $5000 \times \frac{10}{100} = 500$

After tariff the price of imported pair of shoes = Rs. 5 500

Accordingly because of the tariff, the value added of the domestic firm increase to Rs. 2 500

After tariff price of the imported pair of shoes = Rs. 5 500

After tariff value added of the domestic product ion firm = 5 500 - 3 000

$$\frac{2500 - 2000}{2000} \times 100 = 25\%$$

5. What is meant by common market and give some examples? (4marks)

Integration of counties to continue goods and services trade among member countries without trade barriers and which follows a common policy when continuing trade by the member countries with non member countries and which facilitate movement of factors of production is called a common market.. (2Marks)

• Some example for common markets are as follows.

- The Caribbean community and Common Market
- Central American Common Market
- Central African Economic and Monetary Community

(2 X 1 = 2marks)

09. 1. What are the Importance of foreign trade agreement ? (4marks)

- Improvement of cooperation among countries
- Expansion of the market.
- Decrease in cost of transportation.
- Decrease in the prices of domestically produced goods
- Improvement of foreign investments
- Possibility to purchase new industrialized goods at a low price.
- Increase in employment.
- Decrease in the prices of row materials.
- Expansion of the opportunities related to export diversification.

(4 X 1=4marks)

2. What are the Arguments for globalization ? (4marks)

- Non distribution of the benefits of globalization to all citizens of the world fairly.
- More benefits are gained by developed countries.
- Broadening of international income disparities.
- Easy Spread of global economic crisis to other countries of the world.
- Growth of social riots.
- Human lives being unsecured.
- Arising of environmental problems.
- Destroying of culture.

- Arise of economic crisis due to financial market instabilities.
- Loss of employment opportunities due to the collapse of domestic industries. (4 X 1 =4marks)

3. Explain with the use of recent data of the central bank report export structure of Sri Lanka (4marks)

Export structure	2016(%)	2017 (%)	2018(%)
Agricultural goods	22		
Industrial goods	77		
Other	01		

(2 years data 2X2=4 marks)

4. What are the problems facing Sri Lankan Economy to export? Give some suggestions for reducing these problems?

(4marks)

* Pay attention to improve the relationship between Sri Lanka and the global economy.

- Increase economic promotion and marketing programmes at the foreign markets.
- Strengthening of trade agreements productively.
- Protection of new export markets and expansion of existing markets and diversification of goods.
- Establishing of institutions that promote industries which focus exports
- Establishing of a council for export development.

(2X1=2Marks)

5. State four various forms of economic integration

(4marks)

10. 1. What are the Solutions that can be presented for long term deficit of Balance of payment? (4marks)

2. What is meant foreign resource gap? State some reasons to deficit of a foreign resource gap generates? (4marks)

(4marks)

At a given period of time the difference between all foreign receipts and all foreign payments of an economy is known as foreign resources gap.

- Foreign resource gap = foreign receipts – foreign payments (2marks)

reasons to deficit of a foreign resource gap generates

- The value of imports being relatively greater than exports
- Payments of primary income being relatively greater than the receipts of primary income
- High debt payments
- Increase of commercial banks' payments to foreign countries. (2X1 =2marks)

3. What are the Composition of foreign assets? (4marks)

(4marks)

- Monetary gold of Central Bank
- Foreign bank deposits held by the central bank
- Foreign currency held by the central bank
- Foreign securities purchased by the central bank
- Foreign currency held by commercial banks
- Foreign securities purchased by commercial banks

(4 X1 =4 marks)

4. What are the economic effects of devaluation of exchange rate? (4marks)

(4marks)

- Increase in the domestic price of imports
- Increase in import expenditure than before
- Domestic inflation can be increased if domestic demand depends upon imports.
- increase in foreign debt service payment.
- Balance of service account of balance of payments will be favorable due to increase in the earnings from tourism.

- Secondary income account being favorable due to increase in worker remittance including middle east employees remittances.
- Import demand directed towards domestic goods due to discouraging of imports with an increase in price of imports.
- Export earnings can be increased due to increase in demand for exports. (4 X 1 =4 marks)

5. Define nominal effective exchange rate and real effective exchange rate? (4marks)

Nominal effective exchange rate is the unadjusted average rate which determines on the basis of Sri Lanka's 24 major trading partners and which estimated on the weight given to each country based on the size of foreign trade takes place between countries.

- Real effective exchange rate is the exchange rate made adjusting average change of Sri Lanka's inflation rate and other trading partners inflation rate to the nominal effective exchange rate.
- The relationship between nominal effective exchange rate and real effective