

**THE OPEN UNIVERSITY OF SRI LANKA
COMMON WEALTH EXECUTIVE MASTERS OF BUSINESS/PUBLIC
ADMINISTRATION
FINAL EXAMINATION - 2013
ECONOMIC ENVIRONMENT OF BUSINESS – MCP 1605
DURATION THREE (03) HOURS**



DATE: 18th August 2013

TIME: 9.30am – 12.30pm

Answer Part A (40 marks) and any three (03) questions from part B (20 marks each).

PART A

Private sector raises concerns over budget deficit, debt and governance

- * Use of ad hoc mid-night tariff changes signs the govt. is having difficulty maintaining fiscal discipline
- * Transparency, policy consistency, good governance and upholding law and order important Ingredients to build investor comfort

The country's private sector has begun to raise concerns over the government's fiscal performance, mounting public debt and low FDI and export earnings.

The government has made significant macroeconomic gains over the last few years but economists have pointed out that much more needed to be done. The Sri Lanka Economic Association has warned that unless export earnings and FDI flows improved, the country could get into a debt trap. It has argued that fiscal and monetary policy were not conducive to export growth and that governance, transparency and the rule of law were much to be desired and was preventing the country from realizing its potential for attracting FDIs. Economists have also warned that government-spending led GDP growth was not sustainable and military involvement in business activities were counter productive.

The IMF has warned that fiscal consolidation was moving at to slow a pace and that inflation was still too high.

Now, business leaders have also joined in the debate.

Sri Lanka Ceramics and Glass Council President Mahendra Jayasekera addressing the council's recent AGM said, "The taxation reforms introduced a few years ago including reduction of corporate taxes has been encouraging. We also welcome the protection provided to local industries with the introduction of CESS to ward off unfair competition from cheap imports. It is time that the government seriously considers introduction of Anti-dumping legislation which has been in the backburner for over a decade.

"The country has enjoyed stable growth with low inflation for three years. However, the achievement of Government fiscal targets and the lack of control on state expenditure have resulted in increased government borrowings and foreign debt. The use of ad hoc mid-night tariff changes we have experienced recently are signs the government is having difficulty maintaining fiscal discipline. The high level of public debt has stunted growth compared with many other economies and put pressure on the banks. Building investor confidence is very important to attract FDI's and stimulate growth and towards this, transparency, consistent policies, good governance and a vastly improved law and order situation are imperative," Jayasekera said.

Industrial Association of Sri Lanka Chairman Pravir Samarasinghe said, "Although we have enjoyed high and stable growth with low inflation for over three years, an area of concern has been the non-achievement of government fiscal targets and the overshooting of state expenditure resulting in increased government borrowings, and more particularly, foreign debt and the consequential external sector vulnerability."

"The sound management of the economy with consistent policies and maintaining an investor friendly environment is important to sustain economic growth and private sector investment. An important aspect to attract much needed investment and FDI to support the desired growth levels is investor confidence. Transparency, policy consistency, good governance and the upholding of Law and Order are important ingredients to build investor comfort," he said addressing the association's AGM.

Samarasinghe commended the government for some its policies, but said suitable conditions must be created to maintain industry competitive and development, especially with regard to the exports sector.

"We are very pleased with the taxation reforms introduced three years ago with greater rationalization, simplification and reduction of taxes. Steps taken in the last budget by the government to harmonize the BOI and Inland Revenue Department tax regimes are encouraging. These were areas we have continuously highlighted to create an even playing field. We are also encouraged by the government's increased investment in infrastructure which helps build the foundation for economic development. We, however, await more meaningful reforms to our education system to bring about a more demand driven talent pool," he said.

"The lower inflow of FDI and investment into the Industry sector is of concern. Although industry accounts for 30% of our GDP and the factory sub-sector has a major 17% share of this, manufacture grew only by 5% in 2012 down from 8% a year ago. It is important that suitable conditions are maintained for industry competitiveness and development.

"We strongly believe the manufacture of actual tangible goods have true potential to create real value addition to the economy, employment generation to our work force and bring about a meaningful upliftment to our economy and living standards of our people. Hence, it is important that we nurture, protect and foster the growth of industry through the implementation of sound Industrial Policy.

"We strongly believe for us to have a healthy and well balanced economy with high sustainable growth the export sector is of vital importance. Today Industry accounts for 75% of our exports, although its share to GDP has gradually declined over the last two decades. Further, our

industrial export growth declined to 7% last year and has been negative this year with depressed North American and European markets.

"Both the private and government sector must play an important role in reviving our export industry. We must look at alternative markets in Asia and diversify our value added product portfolio.

"Only 5% of our exports are to India. This large and fast growing market provides huge opportunities to our industrialists. Exporting branded and finished goods to the large consumer market and intermediary products and components to the growing manufacturing base in India should be aggressively pursued by our industrialists and we need continued State support to eradicate the unfair barriers for entry into India," Samarasinghe said.

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- a. What is the impact of current Fiscal and Monetary Policies of the Sri Lankan government on the growth of the export sector? Explain. (10 Marks)
 - b. What important role can the government and the private sector play in reviving the export industry in Sri Lanka? (07 Marks)
 - c. "Economists have also warned that government, spending led growth was not sustainable" critically comment. (10 Marks)
 - d. What is the impact of high government borrowings on the private sector investments and expansion? Explain. (07 Marks)
 - e. What is "Anti-Dumping Legislation"? Why is it necessary to have Anti-Dumping Laws? (06 Marks)
- (Total 40 Marks)

PART B

- (2) a. "There will inevitably be market failures in a Pure Free Market Economy". Explain with Example. (6 Marks)
 - b. "The knowledge of Income Elasticity of demand is important for a manager to make effective business decisions". Elaborate with example. (07 Marks)
 - c. What is the nature of elasticity of agricultural products? How does this affect the farmer income when there is a shift in demand and supply of agri. products? Explain using illustrations. (07 Marks)
- (3) a) State whether the following statements are 'true' or 'false'.
 - i. Monopolist will produce only where demand is elastic. (05 Marks)
 - ii. The demand curve faced by a Monopolistic Competitor is more elastic than the demand curve faced by a Perfectly Competitive firm. (05 Marks)

- b) “Both Perfectly Competitive and Monopolistically Competitive Firms make ~~zero~~ economic profits in the long run. However, only Perfectly Competitive firms achieve the maximum efficiency. Firms in Monopolistically Competitive Industry will not realize the maximum efficiency” Do you agree? Explain using illustrations. (10 Marks)
- (4) a) For a market to be called ‘Oligopolistic’ what characteristics must it possess? Explain using examples. (05 Marks)
- b) “Prices in Oligopolistic markets seem to change far less than Perfectly Competitive market. Despite changes in underlying costs of production, firms are often observed to maintain prices at constant level”. Using Kinked Demand Curve Model, explain why there is price stability in Oligopolistic Markets. (07 Marks)
- c) “When firms in Oligopolistic markets collude either explicitly or tacitly, the result is exactly the same as it would be if one firm monopolized the industry” Do you agree? Explain using illustrations. (08 Marks)
- (5) “Economists agree that the government can affect the supply side of the economy. If aggregate supply is to increase, the private sector needs to expand. Towards this the government needs to create an environment in which business can flourish”
- a) i. Using illustrations explain the impact of supply side policies on the overall economy. (04 Marks)
- ii. What major economic variables can supply side policies affect? Explain. (04 Marks)
- iii. To increase the Aggregate Supply through the creation of flourishing business environment, what role can the government play? Explain using example. (07 Marks)
- b) Can the shift in Aggregate Supply Curve create inflation? Explain using Aggregate Demand/Aggregate Supply (AD/AS) frame work. (05 Marks)
- (6) “Although the government can influence the value of their currency, unlike the fixed exchange rate system, when the currency is floating, the ability of governments to influence exchange rate is limited. However a proper administration of the exchange rate policy is vital, as the exchange rate movements have considerable impact on the real economy”.
- a) i. Explain how the exchange rate is determined under;
- Fixed Exchange Rate System.
 - Floating Exchange Rate System
- ii. What are the advantages and disadvantages of each system?(10 Marks)

- b) "Proper administration of the exchange rate policy is vital, as the exchange rate movements have considerable impact on the real economy" Elaborate, taking Sri Lankan economy as an example. (10 Marks)
- (7) "Although countries can gain immensely through free trade, every country chooses to adopt protectionist policies to some extent. There are many ways a country can erect trade barriers".
- i) What are the benefits of free trade? Explain. (06 Marks)
- ii) Citing examples, explain the ways countries can limit free trade in goods and services. (07 Marks)
- i) What arguments have been used to justify the trade protectionism? Explain. (07 Marks)

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