

THE OPEN UNIVERSITY OF SRI LANKA
COMMONWEALTH EXECUTIVE MASTER OF BUSINESS/PUBLIC
ADMINISTRATION
FINAL EXAMINATION – 2014
MCP 1605 – ECONOMIC ENVIRONMENT OF BUSINESS
DURATION: THREE (03) HOURS



Date: 12.08.2014

Time: 1.30 am – 04.30 pm

Answer Part A (40 marks) and Any Three Questions (03) from Part B (20 marks each).

PART - A

The World Bank
Sri Lanka Overview

Almost five years after the end of the three-decade civil conflict, Sri Lanka is now focusing on long-term strategic and structural development challenges as it strives to transition to an upper middle income country. Key challenges include ensuring that growth is inclusive, realigning public spending and policy with the needs of a middle income country, ensuring appropriate resource allocations for the various tiers of government, and enhancing the role of the private sector, including provision of appropriate incentives for increasing productivity and exports.

The Sri Lankan economy has seen robust annual growth at 6.4 percent over the course of 2003 to 2012, well above its regional peers. Following the end of the civil conflict in May 2009, growth rose initially to 8 percent, largely reflecting a “peace dividend”, and underpinned by strong private consumption and investment. While growth was mostly private sector driven, public investment contributed through large infrastructure investment, including post war reconstruction efforts in the North and Eastern provinces. Growth was around 7 percent in 2013, driven by a rebound in the service sector which accounts for approximately 60 percent of GDP. With nearly 2 million Sri Lankans living abroad, overseas employment has contributed with foreign exchange and remittances in the order of 10 percent of GDP in 2013. Overall, unemployment at 4 percent is low, although youth unemployment (ages 15-24) at around 17.3 percent and low female labor force participation at 30 percent do pose a challenge.

Economic prosperity has been broadly shared. Real per capita consumption of the bottom 40 percent grew between 2002 and 2009 by an average of 4.3 percent annually, compared to 2.6 percent of the top 60 percent. As a result, inequality in per capita consumption expenditure fell during this period, as reflected

by a decline in the Gini coefficient from 0.41 to 0.36. Shared prosperity has been associated with dramatic declines in poverty. Among rural, urban and estate sectors, poverty reduction has been particularly dramatic in the estate sector, where it however remains highest at 11 percent.

Sri Lanka has met the Millennium Development Goal (MDG) target of halving extreme poverty and is on track to meet most of the other MDGs, outperforming other South Asian countries.

Whereas South Asia as a whole is on track or an early achiever for nine of the 22 MDG indicators, Sri Lanka manages this for 15 indicators. Among the targets achieved early are those related to universal primary education and gender equality. Sri Lanka is expected to meet the goals of maternal health and HIV/AIDs. Progress on reaching the goals related to malnutrition and child mortality is, however, slower. Indicators are mixed on the environment: while Sri Lanka is an early achiever on indicators of protected area, ozone depleting substance consumption, safe drinking water and basic sanitation, it has stagnated or is slipping backwards on forest cover and CO₂ emissions.

Sri Lanka experienced a big decline in poverty between 2002 and 2009 – from 23 percent to 9 percent of the population. Despite the very positive story of poverty reduction and shared prosperity, important development challenges remain in Sri Lanka. Pockets of poverty continue to exist, specifically in the districts of Batticaloa (in the Eastern Province), Jaffna (in the Northern Province), Moneragala (in Uva Province) and in the estate sector.

An estimated 9 percent of Sri Lankans who are no longer classified as poor live within 20 percent of the poverty line and are, thus, vulnerable to shocks which could cause them to fall back into poverty.

Climate-related hazards pose a significant threat to economic and social development in Sri Lanka.

Extreme variability of rainfall is the defining feature of the country's climate. With climate projections indicating a rising rainfall trend in the wet zone and decreasing rainfall trend in the dry zone, the risks associated with water-related climate variability are expected to intensify. Less and less frequent precipitation in the already dry areas could increase the frequency and duration of droughts while higher and more variable rainfall is expected to increase the frequency and intensity of floods, affecting monsoon-dependent areas in particular. Climate change is expected to significantly impact agriculture, water resources, energy, environment and fisheries in Sri Lanka.

Last Updated: Mar 31, 2014

- (1) a) How conducive is the current Macro-Economic Environment for private sector expansion? Explain taking the current Fiscal/Monitory policy stance of the government into consideration. (12 marks)
- b) “While growth was mostly private sector driven, public sector contributed through large infrastructure investment”. How far do you agree with this statement? Critically comment. (09 marks)
- c) It is argued that large scale infrastructure development through high government borrowing (public/private) is not conducive for long term economic growth of a country. Explain the impact of high government borrowing on the economy. (08 marks)
- d) Now that Sri Lanka is in the category of lower middle income country, some economists point out that, policy makers should ensure that Sri Lanka avoid getting into a middle income trap. What does this statement mean? (05 marks)
- e) The article highlights that climate related hazards pose a significant threat to economic development of Sri Lanka. Briefly explain the impact of climate related hazards on the economy? (Provide economic reasoning) (06 marks)
- Total – (40 marks)

PART – B

- (2) a) Using illustrations explain how the knowledge of Demand and Supply analysis help you in explaining the following given situations.
- i. Due to lighter weight and increased access to wireless technology, the demand for laptop computers has increased substantially. Production of laptops too has become easier and cheaper because of the improvement in production technology. Overall there has been a decline in the market price for laptop computers.
 - ii. Medical experts have continuously brought the attention of people of positive impact of consuming rice on human health. Further, improvements in Agriculture technology have reduced the post harvest losses in rice production. Overall there has been an increase in the price of a kilo of rice in the market.
- (10 Marks)

- b) “Minimum legal price can lead to excess supply and tend to be maintained only at the expense of the tax payer” Do you agree? Explain using illustrations. (04 Marks)

- c) Use demand and supply analysis to answer the following (Provide illustrations)

Steel is demanded for both car manufacturing and shipbuilding.

- i. There has been a worldwide recession. How would this affect the car market and also the steel market?
- ii. There has been an increase in orders for ship building. How would this affect the steel market for ship building and also for steel market for car manufacturing? (06 Marks)

- (3) a) Providing reasons explain whether you “agree” or “disagree” with the following statements.

- i. Responsiveness of consumers to changes in price is generally greater for a product brand than for a product category.
- ii. Nature of Cross-Price Elasticity for substitutes is negative (-) and for complementary, positive (+), where as nature of Advertising Elasticity for Substitutes is positive (+) and complementary, negative (-). (09 Marks)

- b) Consider the information in relation to goods ‘x’ and ‘y’ provided below.

Good ‘x’	Good ‘y’
A large number of substitutes available.	Only a few substitutes available
A high percentage of person’s income is spent on the good.	A small percentage of person’s income is spent on the good.
A luxury good.	A necessary good.

Firm producing goods x and y is contemplating on increasing the price of both x and y, in order to increase the revenue generated from these goods.

How do you advise the management of this firm on their decision to increase price? Explain your answer, using illustrations.

(06 marks)

- c) The value of Income Elasticity of two goods given as;

Good	Income elasticity
Bus travel	-0.58
Foreign travel	+1.68

How would the demand for both goods change under recessionary and booming economic conditions? Explain. (05 Marks)

- (4) Using illustrations explain whether you “agree” or “disagree” with the following statements.

- a) The Long Run Equilibrium of Perfectly Competitive Model is considered as the benchmark for allocative efficiency. Accordingly, Monopolistically Competitive Firms fail to achieve allocative efficiency in the long run.
- b) Production in a Monopolistic Environment compared to a Perfectly Competitive one, is undesirable from the point of view of ‘society’.
- c) Firms operate in Oligopolistic markets often benefit if they collude. (20 marks)

- (5) a) i. What factors cause the Aggregate Demand Curve to slope downward? Explain.
 ii. Illustrate and explain what is meant by the Classical, Keynesian and Intermediate range of the Aggregate Supply Curve. (05 Marks)

- b) Using Aggregate Demand/Aggregate Supply (AD/AS) Framework explain impact of following events on the country’s economy. Discuss the impact considering the economy’s Aggregate Demand intersects the Aggregate supply in the intermediate range of AS.
- i. There has been a considerable improvement in the production technology.
 - ii. The government has increased the personal income tax.
 - iii. There has been a drop in level of exports.
 - iv. There has been a visible improvement in the Capital Stock of the Country.
 - v. A research has identified that productivity of the labour force has gone down. (15 Marks)

- (6) a) Explain how the Exchange Rate of a country is determined under;
- i. Fixed Exchange Rate System.
 - ii. Floating Exchange Rate System. (04 Marks)
- b) “The government can tackle a current account deficit by devaluing its domestic currency or allowing it to depreciate. However success of this, to some extent depends on Import – export elasticity”.
- i. How would the depreciation/devaluation help a country to tackle a current account deficit? Why does it depend on import-export elasticity? Explain.
 - ii. What are the problems associated with devaluation? Explain. (09 Marks)
- c) a) Free trade has brought about major welfare gains to countries around the world. However trade protectionism has also been widespread”.
- i. What are the gains from trade?
 - ii. What arguments justify the trade protectionism? Explain. (07 Marks)

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