

THE OPEN UNIVERSITY OF SRI LANKA

COMMONWEALTH EXECUTIVE MASTER OF BUSINESS/PUBLIC ADMINISTRATION

FINAL EXAMINATION – 2016

ECONOMIC ENVIRONMENT OF BUSINESS – MCP1605

DURATION: THREE (03) HOURS



DATE: 16.07.2016

TIME: 9.30 a.m. – 12.30 p.m.

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

Part- A

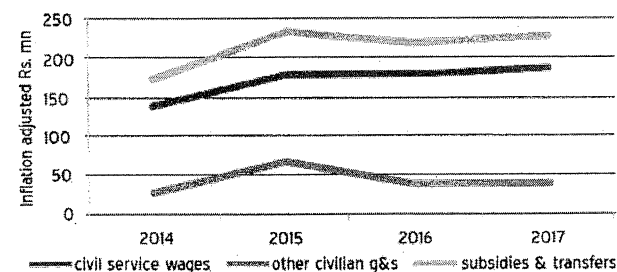
Question No. 01

Sri Lanka's Extended Fund Facility arrangement with IMF: It's mostly fiscal

By Dushni Weerakoon

The often repeated pun on the International Monetary Fund's (IMF) acronym satirically suggests that it prescribes a tighter fiscal policy, whatever an economy's problem might be. Indeed, lower budget deficits and higher government revenues are central to Sri Lanka's latest US \$ 1.5 billion loan from the IMF. But, the economy's booms and busts of recent years – including the current economic distress – go beyond merely the fiscal; much of it has manifested in the monetary and exchange rate policy spheres. It is hard, however, to get away from the argument that all roads lead back to the fiscal quandary; the frequent devaluation of the rupee for example, is a reflection in the monetary sphere of fundamental imbalances in the real economy – production, consumption and investment. And fiscal policy is where the adjustments begin.

Figure 1: Current Expenditure



Source: IMF Staff Report for the 2016 Article IV Consultation

Table 1: Selected Economic Indicators, 2015-2020

		2015	2016	2017	2018	2019	2020
Real GDP growth	%change	4.8	5.0	5.0	5.0	5.2	5.4
Average inflation	%change	0.9	4.1	5.3	5.1	5.0	5.0
Export value growth	%change	-5.6	-0.5	4.6	8.2	7.0	11.3
Fiscal balance	% of GDP	-6.9	-5.4	-4.7	-4.0	-3.7	-3.5
Public debt	% of GDP	76.0	77.2	75.5	73.1	70.7	68.2
Private savings	% of GDP	28.0	27.8	25.9	24.8	24.2	23.6
Private investment	% of GDP	21.9	21.9	21.9	21.9	21.9	21.9

Source: IMF Staff Report for the 2016 Article IV Consultation.

The imbalances besetting the Sri Lankan economy produces 'twin deficits': budget deficits that mean debt is piling up and current account deficits that indicate overriding reliance on foreign capital inflows. At the heart of it, the imbalances mean a) national expenditure exceeds national income and b) production of tradable goods and services is inadequate. So long as foreigners are willing to finance the external current account deficit, the economy can muddle along. But, if there is a reversal of such flows, as happened in 2015 (that coincided with a sharp increase in fiscal imbalances), painful adjustments have to be made.

A current account deficit can be addressed by either cutting national expenditure or raising income. The latter cannot be increased sufficiently in the short term as gross domestic product (GDP) growth typically increases expenditures and productivity improvements take time. Alternatively, governments can attempt to switch resources to produce more tradable goods and services. This calls for a depreciation of the currency. But, a nominal depreciation alone is insufficient; expenditures must also be reduced to keep domestic cost increases at bay and ensure that a real depreciation of the currency takes place.

Sri Lanka's IMF programme signed in June 2016 has built all these elements into its framework – fiscal tightening, a soft inflation target, and a flexible exchange rate regime. Within this framework, GDP growth is expected to remain at a modest 5 percent in the medium term, while export earnings are forecast to grow steadily (Table 1). Clearly, imbalances are to be addressed in the short term by 'switching resources' (flexible exchange rate) rather than attempting to boost national income. For a real depreciation of the currency to occur, expenditure (consumption or investment) must be reduced. Therefore, the government and/or private sector (firms and households) must curtail spending. This is being done by cuts in both current public spending as well as tax increases.

The government's current expenditure is to reduce from 15.2 percent of GDP in 2015 to 13.9 percent in 2016. Generous relief measures offered in 2015 will take a cut in real rupee terms in 2016-17; household disposable incomes will drop as fiscal expenditures on public sector salaries and wages, expenditures on other civilian goods and services and transfers and subsidies (of which nearly 80 percent go to households) are squeezed (Figure 1). On the revenue side too, households' disposal incomes and firms' profits will be impacted with projected increases in collection from value-added tax (VAT) and income taxes (Table 2). Not surprisingly, the overall macroeconomic framework points to declining private savings as a share of GDP, while private investment stagnates at 21.9 percent of GDP in the coming years (see Table 1).

While focusing on fiscal policy, the response of monetary authorities will also be critical to the question of who bears the cost of adjustment. If the rupee is not allowed to float freely, interest rates will rise, increasing the cost of credit to firms and households, and thereby reducing domestic expenditures. The prudent option is to allow the rupee to move freely on underlying economic fundamentals. Monetary policy can then be more stimulative to support growth, discouraging savings and encouraging borrowing (as the predicted savings-investment figures seem to suggest).

Overall though, there is little room to provide a fiscal and/or monetary policy stimulus to accelerate growth in the near term, evident by the IMF's modest 5 percent medium-term growth estimate. It will draw the usual criticism that fiscal austerity leads to a stagnant or

shrinking economy, at least in the short run, and exacerbates debt burdens needlessly. However, there is no realistic alternative to fiscal tightening; Sri Lanka has pushed itself to a corner, dragging public finances down with low-tax receipts and unaffordable spending sprees.

What the economy needs most today is a credible fiscal consolidation plan that will restore macroeconomic stability and investor confidence in the country. If the only means of getting there is inking an agreement with the IMF, then it is incumbent on the government to deliver on the terms swiftly. The loan amount, spread over three years, is relatively small. In the circumstances, Sri Lanka needs to act early and decisively to fully leverage the IMF deal as a confidence-restoring measure in its efforts to attract investment flows, both local and foreign.

Business Mirror – 08th July 2016

- (a) Why it is believed that the higher budget deficits today will reduce the growth rate of the economy in the future? Explain.

Do the reasons for the higher budget deficit matter?

(07 marks)

- (b) The governments can tackle the current account deficit by devaluing the domestic currency or allowing it to depreciate.

i) How would the devaluation/depreciation help a government to tackle its current account deficit? Do the import/export elasticities matter when tackling current account deficit through devaluation/depreciation? Explain with examples.

ii) What are the problems associated with devaluation/depreciation of a currency?

(09 marks)

- (c) “Investments on non-tradable sectors acts as a catalyst to develop the tradable sector, yet it is important to channel more investments on tradable sectors.” Do you agree with this statement? Explain.

(06 marks)

- (d) “What the economy needs most today is a credible fiscal consolidation plan that will restore macro-economic and investor confidence in the country.”

i) What is meant by fiscal consolidation? Explain.

ii) How will the fiscal consolidation restore macro-economic stability and investor confidence? Explain.

(08 marks)

- (e) What factors have contributed to the poor export sector performance in year 2015 to 2016? Explain.

(05 marks)

- (f) Can the fiscal austerity lead to a stagnant or shrinking economy at least in the short run? Explain.

(05 marks)

(Total 40 marks)

Part- B

Question No. 02

- (a) “Price rationing mechanism in free markets is sometimes viewed as unfair. Attempts to use alternative rationing mechanism could be more difficult and costly than they would seem at first glance” Do you agree? Explain taking “Minimum wage law” and short and long run impact of “Rent Controls” as examples. Use illustrations to explain your answer. (07 marks)
- (b) Use demand and supply analysis to explain the following. Provide illustrations.
- (i) To maintain the price of rice, the government decides to pay the rice farmers a cash subsidy for every acre that they leave unplanted. What is the impact of this on rice market?
 - (ii) Suppose the government imposed a quota restriction on importation of Japanese motor vehicles. What is the impact of this on the local market for motor vehicles manufactured in Japan and also for motor vehicles manufactured in other countries. (07 marks)
- (c) The government has a wide range of policies that it could use to bring about an efficient allocation of resources where externalities exist. Using illustrations explain how the government can make the resource allocation efficient under following given situations.
- (i) A chemical plant dumping waste into a nearby river.
 - (ii) Immunisation programme against a life –threatening disease (06 marks)

Question No. 03

Use the knowledge in relation to concept of elasticity to answer the following given questions. Provide Examples/illustrations where appropriate.

- (i) Why are the governments tend to mostly impose taxes on items like alcohol, tobacco and patrol? (04 marks)
- (ii) Why could the bumper crops be disastrous for farmers? (03 marks)

- (iii) Why would the value of price Elasticity of Demand for Lux be higher than the price Elasticity of Demand for soap? (02 marks)
- (iv) The value of Price Elasticity of Demand for news papers given as -0.38 and for restaurant meals in the city restaurants given as -1.24 could both the newspaper publishers and owners of city restaurants increase the price of their respective products to increase their revenues. Explain. (04 marks)
- (v) The value of Cross Price Elasticity for substitutes is positive (+) and for complementaries negative (-), could the signs of Advertizing Elasticities be the same for substitutes and complementaries? (04 marks)
- (vi) Why did the importation of motor vehicles increased considerably when the government once reduced the tax imposed on motor vehicles? (03 marks)

Question No. 04

- (a) "In the real world there is no industry which confirms precisely to the market model of Perfect Competition, but it does not mean that the model is of little practical value" Do you agree? Explain. (05 marks)
- (b) Explain whether you "agree" or "disagree" with the following statements. Use illustrations to explain your answer.
 - (i) Monopolists earn long run economic profit which contrasts with zero economic profit in the long run for a Perfectly Competitive firm.
 - (ii) Because price equals long run average cost and economic profits are zero firms in Monopolistically Competitive industry can achieve maximum allocative efficiency in the long run.
 - (iii) Monopolist can appropriate consumer surplus through Price Discrimination and further increase its abnormal profit. (15 marks)

Question No. 05

- (a) (i) "There is a great deal of disagreement concerning the shape of the Aggregate Supply Curve (AS). The shape of the AS curve matters when understanding impact of expansionary fiscal/monetary policies." Do you agree? Explain highlighting Keynesian and Classical views in relation to shape of AS curve.
- (iii) What factors make the Aggregate Demand Curve (AD) negatively sloped? Explain. (08 marks)
- (b) Using AD/AS framework to illustrate your points discuss the impact of following events on the price level and on equilibrium $GDP_p(Y)$ in the short run

- (i) A reduction in personal income tax.
- (ii) An increase in the price of oil in the world market assuming that the Central Bank attempts to keep interest rates constant by accommodating inflation.
- (iii) Application of expansionary Monetary policy during a period of high unemployment and excess industrial capacity.
- (iv) Destruction of economy's capital stock due to a natural disaster. (12 marks)

Question No. 06

- (a) Even if a country has no absolute advantage in the production of any good international trade will be advantageous, so long as it has a comparative advantage in the production of one good" Do you agree? Explain using an example. (07 marks)
- (b) Trade barriers prevent a nation from reaping the benefits of specialization, push it to adopt relatively inefficient production techniques, and force consumers to pay higher price for protected products than they would otherwise pay".
 - (i) What are the forms of trade barriers? Explain using examples/illustrations where necessary.
 - (ii) What are the arguments developed in favour of trade protection? Explain.
 - (iii) Do you "agree" or "disagree" with the above statement. (13 marks)

Question No. 07

Explain whether you "agree" or disagree" with the following statements.

- (i) The goal of Macro Economic policy makers should be to reduce the measured unemployment rate to zero.
- (ii) Banks do not create money, it is the responsibility of the Central Bank.
- (iii) During a recession investment may not respond positively to low interest rates and also during a boom investments may not respond negatively to high interest rates.
- (iv) When the inflation rate increases in the domestic country while it remains constant in other nations, the value of the domestic currency will appreciate.
- (v) When real interest rate in the domestic country rise, while real interest rate elsewhere remains constant, the value of domestic currency will appreciate.

(4 x 5 = 20 marks)

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