



**THE OPEN UNIVERSITY OF SRI LANKA
THE COMMONWEALTH EXECUTIVE MASTERS OF BUSINESS/PUBLIC
ADMINISTRATION
FINAL EXAMINATION – 2018
ECONOMIC ENVIRONMENT OF BUSINESS – MSP 9405/ MCP 1605
DURATION – THREE (03) HOURS**

DATE – 21.07.2018

TIME – 9.30a.m. – 12.30p.m.

Answer Part A (Question No.01), (40 Marks) and any three questions from Part B (20 Marks each)

PART - A

Central Bank says relationship between credit and economic growth weakening

- Recent CB study reveals reason for low growth is not cost of finance
- Urges govt. to put weight on reforms, trade policy to drive future growth
- Warns monetary policy loosening could now play into BOP crisis
- Rules out any monetary loosening due to political pressures
- Says will revise down this year's growth forecast to 4-4.5%
- Vows to address tight liquidity conditions through open market operations
- New framework for data collection to determine speculative depreciation in FX market

The Central Bank has urged the government to put more weight on factor market reforms, improving investment climate and capitalizing the country's geographical location through trade policy in order to boost future economic growth, as the relationship between credit growth and economic expansion is on a weakening trend, while the loosening of monetary policy is not an option considering the current global environment as well as Sri Lanka's deteriorating trade deficit.

Addressing the monetary policy review press conference last Friday, the Central Bank Governor, Dr. Indrajit Coomaraswamy asserted that with a deteriorating trade deficit and a current account deficit amid rising international rates, it is not prudent for Sri Lanka to relax its monetary policy for short-lived consumption-led economic boost.

"If we were to compress our interest rates, the difference between ourselves and the benchmark U.S. Treasury rates would lead to an acceleration of outflows from the rupee denominated treasury market where there is little of more than US \$2 billion.

If you loosen the monetary policy when trade deficit is worsening or the current account is deteriorating, clearly you could play into a BOP crisis," Dr. Coomaraswamy pointed out. Moreover, he noted that a recent study carried out by the Central Bank's Economic Research Department under the guidance of Senior Deputy Governor, Dr. P. Nandalal Weerasinghe, has found that the relationship between credit growth and economic expansion had been weakening.

"So the reason for low growth is not cost of finance. There are many other things such as confidence in the country, sentiment on expectations, structural problems etc. which need to be addressed," he

stressed.

The Central Bank chief acknowledged that the 5 percent growth target for the year has become "a very ambitious target" considering the 3.2 percent growth recorded for the first quarter of this year.

Hence, he noted that the Central Bank is likely to revise down the growth outlook to 4-4.5 percent at the next monetary policy announcement media briefing. However, Dr. Coomaraswamy was confident that the economic growth will pick up during the second half of the year. He also ruled out any monetary policy relaxation due to political pressure as next election cycle is approaching, and stressed that the Central Bank is engaged in a data-driven monetary policy. "If you look at inflation which is running around 4 percent, growth is little over 3 percent while nominal GDP is growing at about 8 percent. Yet the credit growth comes to around 15 percent, so there's plenty of money, there are no tightness in terms of availability of money," he reiterated. The Governor pointed at the fact that the Sri Lankan economy had grown at a much faster rate with much high interest rates in the past, and in some instances the high credit growth necessarily didn't result in high growth.

"For instance, when inflation was 10 percent, you had interest rates well above what they are now. Yet there was higher growth and not only that, if you look at the first half of 2016, there was a credit growth of 28 percent, and the growth was still less than 4 percent," he noted. The private sector credit growth decelerated to 15.1 percent year-on-year in May 2018 from 15.3 percent in April 2018. CBSL expects private sector credit to grow by around 13-14 percent by the end of 2018.

However, Dr. Coomaraswamy admitted that liquidity conditions are currently tight and vowed to address the tightness of the liquidity in the market through the Central Bank's open market operations. Meanwhile, he announced that the Central Bank is in the process of putting in place a new framework for data collection to determine speculative depreciation in forex markets. "Even with the data we have, it's hard to separate the speculative depreciation from fundamentals. We are now putting in place a framework for data collection," he said. The Central Bank has intervened in the domestic forex market to address the speculative behaviour and the unwarranted volatility in the exchange rate, and absorbed US \$141 million net foreign exchange in the first half of 2018 in defending the currency. The rupee has depreciated 3.6 percent against the U.S dollar so far this year. Dr. Coomaraswamy emphasised that the inflation outlook remains favourable and the Central Bank's expectation surveys indicate that inflation expectations are fairly well anchored. The Central Bank expects the inflation would remain at the desired mid-single digit levels during the remainder of the year and over the medium term, supported by appropriate policy adjustments.

By Nishel Fernando

Daily Mirror; 09 July 2018

Question No 01.

- a) Explain the relationship between credit growth and economic expansion. What is meant by “the relationship between credit growth and economic expansion is on weakening trend? How could it be possible? (05 Marks)
- b) What is meant by “loosening of monetary”? How could the loosening of monetary policy affect the economic environment in general and business organizations/investments in particular? Explain. (07 Marks)
- c) According to the article what factors contributed to the slowing down of domestic economic growth? How could these factors have affected the economic growth? Explain (07 Marks)
- d) It says that “Sri Lankan economy had grown at a much faster rate with much higher interest rates in the past”. Explain why investments may not positively respond to lower interest rate at time of recession and it may not respond negatively to higher interest rate at a time of boom?(06 Marks)
- e) What is meant by deteriorating trade deficit and a current account deficit? Explain (03 Marks)
- f) It is believed that the persistent current account deficit can be tackled through devaluation/depreciation? Explain how the current account deficit could be handled through the said method. (06 Marks)
- g) Explain the impact of depreciating currency on domestic economy in general and business organizations in particular. (06 Marks)

(Total Marks 40)

PART - B**Question No 02.**

- a) “Legally fixed prices stifle the rationing function of price and distorts the allocation of resources “ Explain the validity of the said statement taking “minimum legal wage” and “rent controls” as examples. Use illustrations to explain your answer. (07 Marks)
- b) “Unlike private goods, the low or even zero demand caused by free riding make it virtually Impossible for private firms provide public goods”.
 - I. Distinguish between “Private Goods” and “Public Goods”.
 - II. What is meant by “free riding make it virtually impossible for private firms to provide Public Goods”? Explain. (06 Marks)

- c) Explain how the market failures occur in relation to the following.
- Coal burning power plant
 - Immunization programme that reduces disease and death

What kind of government intervention is necessary to ensure efficient allocation of resources in relation to the examples stated above? Explain using illustrations. (07 Marks)

Question No 03.

- a) "For policy makers achieving the goal of higher total farm income requires that farm output be restricted" Considering the nature of elasticities of farm products explain whether you "agree" with the given statement. Use illustrations to explain your answer. (05 marks)
- b) "The government pays attention to elasticity of demand when it select goods and services on which to levy taxes". Explain why the policy makers mostly prefer to levy taxes on goods such as cigarettes, fuel, liquor etc. Would the same outcome be expected if taxes are levied on upmarket motor vehicles? Use illustrations to explain your answer. (06 Marks)
- c) "The greater the amount of time producers have to adjust to change in demand, the greater will be their output response" How valid is the given statement? Explain in relation to how a tomato Producer can respond to increase in demand, in the immediate market period, in the short run and also in the long run. Use illustration to explain your answer. (09 Marks)

Question No 04.

- a) Using illustrations explain how the entry of firms into industry affects the demand curve facing a Monopolistic competitor and how that in turn affects the economic profits in the long run. Could the employment of non-price competitive methods improve the profitability of Monopolistically Competitive firms? Explain. (08 Marks)
- b) Using kinked Demand curve model explain why prices are generally stable in non-collusive Oligopolies? Under unstable macro-economic conditions can the Oligopolies maintain rigid prices as theory suggests? Explain using illustrations. (07 Marks)
- c) Can Oligopoists often benefit from collusion? Explain. (05 Marks)

Question No 05.

- a) What are the factors that shift the Aggregate Demand (AD) and Aggregate Supply (AS) in an economy? Explain. (05 Marks)
- b) How would the AD/AS model explain the periods of Demand Pull inflation, Cost Push inflation, and recession? Provide illustrations to explain your answer. (08 Marks)
- c) Governments generally tend to resort to higher taxation, both direct and indirect to increase revenue and reduce both budget deficit and debts. Using illustrations critically analyze the demand and supply side impact of higher taxation. (07 Marks)

Question No. 06.

- a) "Countries trade because it is beneficial." What are the benefits of trade? Explain with examples. (03 Marks)
- b) Using illustrations explain the economic effects of "Tariffs" and "Quotas". (06 Marks)
- c) Using examples explain how the countries use Non Tariff Barriers (NTB) to limit free trade. (06 Marks)
- d) What are the specific arguments and appeals that are made to justify protectionism? Explain. (05 Marks)

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