

STRICTLY CONFIDENTIAL

**THE PUBLIC ACCOUNTS EXAMINATION COUNCIL
OF MALAWI**

2011 EXAMINATIONS

ACCOUNTING TECHNICIAN PROGRAMME

PAPER TC 5: ECONOMICS

(JUNE 2011)

TIME ALLOWED: 3 HOURS

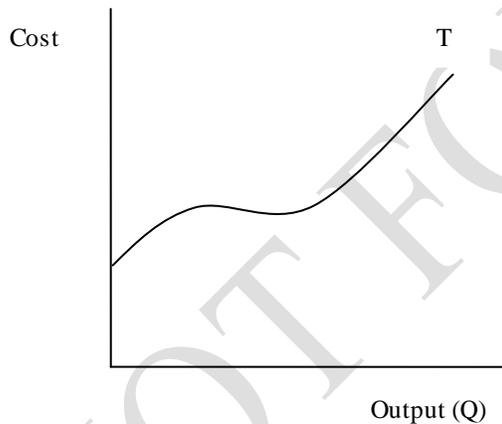
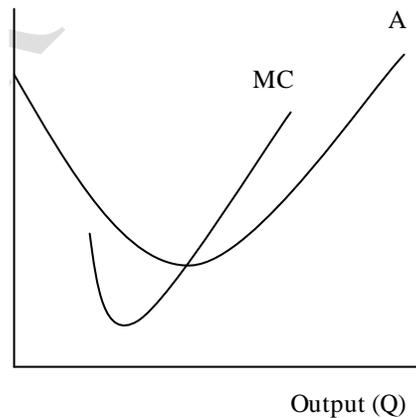
NOT FOR SALE

SUGGESTED SOLUTIONS

1. (a)

Units of output	Total cost	Average cost	Marginal cost
1	10	10	10
2	15	7.5	5
3	18	6	3
4	26	6.5	8
5	35	7	9
6	46.2	7.7	11.2

(b) (i) The graphs below indicate the total cost (TC), average cost (AC) and marginal cost (MC). The graphs also show the relationship between marginal cost and average cost when the latter is at its minimum point.

**2 Marks****4 Marks**

(ii) The marginal cost curve intersects the average cost curve at its minimum point from below, implying that as long as marginal cost curve is below average cost curve, the average costs of production will be decreasing. Likewise, if marginal cost is above average cost, average cost of production must be rising. In the long run where all the factors of production are variable, any points before marginal cost curve cuts average cost curve would imply that a firm is enjoying economies of scale. After the marginal cost curve intersects the average cost curve, a firm would be experiencing diseconomies of scale.

2. (a) Economies of scale are the reduction in a firm's long run average costs as a result of increasing production. As firms grow in size it is possible for them to reduce their average cost of production.
- (b) The following are the **six** sources of internal economies of scale in an organization:
- (i) Specialization of labour – In a large undertaking, a highly skilled worker can be employed in a job which makes full use of his/her skill.
 - (ii) Division of labour – Due to specialization of labour, there is also division of labour, i.e., work is divided between several specialists each of whom contributes his/her share to the final product.
 - (iii) Dimensional economies – These refer to the relationship between the volume of output and the size of the equipment needed to hold the output. For instance, the cost of a container for 10,000 litres of product will be much less than ten times the cost of a container for just 1,000 litres.
 - (iv) Buying economies – This refers to the reduction in the cost of material purchases through bulk purchase discounts.
 - (v) Marketing economies – These are made available because a firm can make more effective use of advertising, specialist salesmen, and specialized channels of distribution.
 - (vi) Stock holding – The most economic quantities of inventory to hold increase with the scale of operations but at a lower proportionate rate of increase.
- (c) The following are the **three** ways in which a firm can experience external growth:
- (i) Vertical integration – this occurs when firms amalgamate at different stages of the productive process. Vertical integration can be divided into backward and forward integration. Backward vertical integration refers to a situation where one firm amalgamates with another firm at an earlier stage of the productive process. Forward vertical integration, on the other hand, is where a firm acquires another firm at the next stage of the productive process.
 - (ii) Horizontal integration – occurs when a firm amalgamates with another firm at the same stage of the productive process.
 - (iii) Conglomerate integration – this occurs when firms merge with no obvious link between the goods and services they produce.

3. Some policy makers have argued that although many rural farmers in Malawi are hard working, they are not necessarily efficient and productive.

(a) The following are **six** factors that explain efficiency and productivity of labour:

- (i) The attitudes of rural farmers.
- (ii) The intelligence and skills of rural farmers.
- (iii) The attitudes of the farmer's clubs to which the individual belongs.
- (iv) Established work practices and trade union influence.
- (v) The skill of management in getting the best out of a workforce.
- (vi) The extent to which farmers can make use of other factors of production.

(b) **Four** factors that can influence demand for rural agricultural products in Malawi's urban sectors are as follows:

- (i) Price of the agricultural products.
- (ii) Quality of the agricultural products.
- (iii) Easiness in accessing agricultural products from the rural areas.
- (iv) Flow of information between the rural and urban centres.

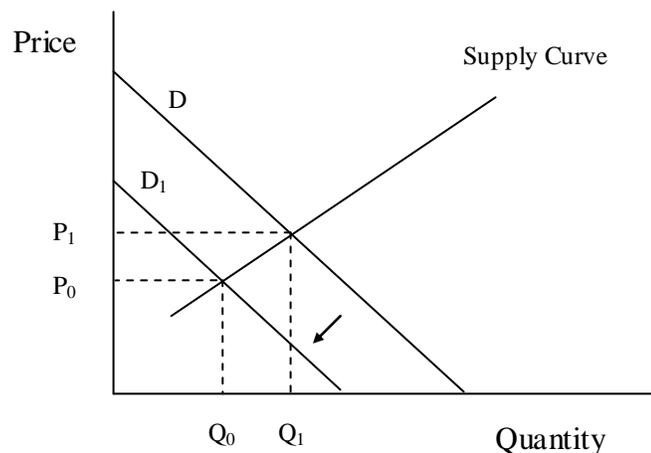
Note: Other points may be considered.

(c) Assuming rural farmers formed a union to help them sell their products locally as well as internationally, the following **five** points would determine their union's success.

- (i) The union's size, financial resources and negotiating skills.
- (ii) The ability of the union to control the supply of labour.
- (iii) The economic viability of the agricultural industry.
- (iv) Relations between the union and the government, and the nature of any new employment legislation.
- (v) The substitutability of capital for the farmers whom the union represents.

4. (a) **Four** factors that determine demand for Internet café in Malawi include:

- (i) **Price of Internet products.** An increase in prices of Internet café products, *ceteris paribus*, will lead to reduction in the number of people going for them and vice versa.
- (ii) **Price of substitute products.** An increase in prices of substitute products will lead to increase in demand for Internet café and vice versa.
- (iii) **Size of household income.** An increase in household income will lead to increase in demand for Internet café (assuming Internet café is a normal product).
- (iv) **Taste and fashion.** If the taste or preference for Internet café increases probably due to timeliness, then there will be increase in demand for their services.
- (b) The following reasons make the Internet café industry imperfect to some degree:
- (i) Buyers usually have incomplete information about prices.
- (ii) Producers (Internet café) can create an impression that their café are better than those of their competitors, although they are really quite similar.
- (iii) Customer loyalty or inertia sometimes prevents rational decisions by internet users. For instance, some people visit particular Internet café just simply because they like the owners or because they are used to such places.
- (c) Inferior goods are the ones whose demand decreases as income rises. An increase in income will therefore lead to reduction in demand for product x as indicated in the graph below:



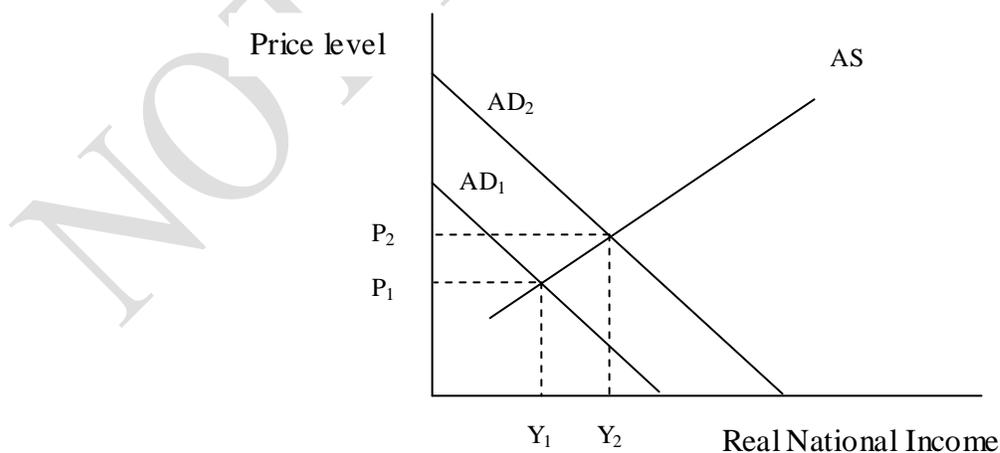
From the graph above, initially the equilibrium price and quantity are P_1 and Q_1 , respectively. This occurs where demand curve, D intersects the supply curve. An increase in income leads to decrease in demand as shown by a shift in demand curve from D to D_1 . This leads to decrease in equilibrium price from P_1 to P_0 and a decrease in equilibrium quantity from Q_1 to Q_0 .

5. (a) Trade cycles (business cycles) are the continual sequence of rapid growth in national income, followed by a slow-down in growth and then a fall in national income (recession). After recession may come growth again, and when this has reached a peak, the cycle turns into recession once more.
- (b) **Three** views about Pre-Keynesian theories of trade cycles are explained as follows:
- (i) Recovery after a slump begins with a rise in investment. It was believed that the rise in investment was caused by a fall in interest rates to the point where it became profitable to borrow and invest, or due to fall in wage rates that would lead to increase in investment.
 - (ii) Once investment begins to rise, more labour will be employed. As a result of increased demand for labour, wages rise leading to increase in household income. This would lead to an increase in consumption and hence stimulate further investment.
 - (iii) Eventually, the upswing flattens out. It was believed that the beginning of the downturn was caused by over-investment in capital goods industries during the boom years. Surplus capacity in these industries eventually leads to redundancies, culminating in a fall in household income and consumption – marking the beginning of the downturn.
- (c) **Three** ways in which government can try to reduce the upswing of a trade cycle.
- (i) By encouraging investment so as to give a boost to it.
 - (ii) By increasing government spending and finance the extra spending with borrowing instead of matching the increase in government spending with an increase in tax.
 - (iii) By encouraging more consumer spending, by reducing taxes so as to put more money into the pockets of consumers, but to keep government spending at the same level and so run a budget deficit.

- (d) **Three** ways in which government can influence private investment in an economy include the following:
- (i) By controlling interest rates. By keeping interest rates low, government might encourage higher volume of investment.
 - (ii) By providing direct encouragement to investing firms, by offering investment grants or by providing tax incentives.
 - (iii) Government can stimulate business confidence by developing and announcing an economic policy for continued growth, and then achieving policy targets.
6. (a) Economic growth is an increase in national income in real terms.
- (b) **Five** factors necessary for economic growth are as follows:
- (i) There must be sufficient skilled labour.
 - (ii) There must be sufficient capital.
 - (iii) There must be land availability and suitable infrastructure.
 - (iv) There must be good government policies geared towards economic growth.
 - (v) International trade must be encouraged.
- (c) **Three** potential disadvantages to economic growth are:
- (i) Faster use of the earth's natural resources due to rapid growth.
 - (ii) Creation of pollution by too much economic activities.
 - (iii) Failure to adapt to the new demands for new skills and training by some sections of the population.
- (d) **Three** tasks of economic reorganization are:
- (i) To encourage firms to move into new growth industries.
 - (ii) To encourage new investment by firms.

- (iii) To encourage training so that a skilled labour force is available to do the work in the new industries.
- (e) **Four** reasons for governments being recommended to pursue structural adjustment programme are:
- (i) To promote competition in the market.
 - (ii) To increase flexibility and international mobility of resources of production.
 - (iii) To promote free trade.
 - (iv) To increase the efficiency of the public sector.
7. (a) Inflation is a general and persistent upward movement in the level of prices, which makes the price level to rise and money lose value.
- (b) Demand-pull inflation occurs when the economy is buoyant and there is high aggregate demand that is in excess of the economy's ability to supply. This pulls up prices to a situation where there is too much money chasing too few goods. One way in which demand-pull inflation occurs is when there is an increase in credit lending by banks. Borrowers use their loans to spend more and there is an increase in the money supply as the money lent by banks finds its way back into the banks as customers' deposits.

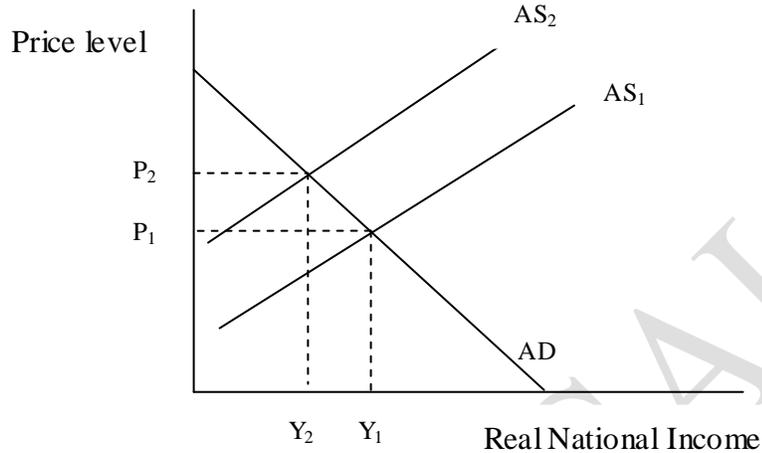
(Alternatively) The graph below illustrates demand-pull inflation.



An increase in demand is illustrated by a shift in AD from AD_1 to AD_2 and the resulting increase in the price level from P_1 to P_2 .

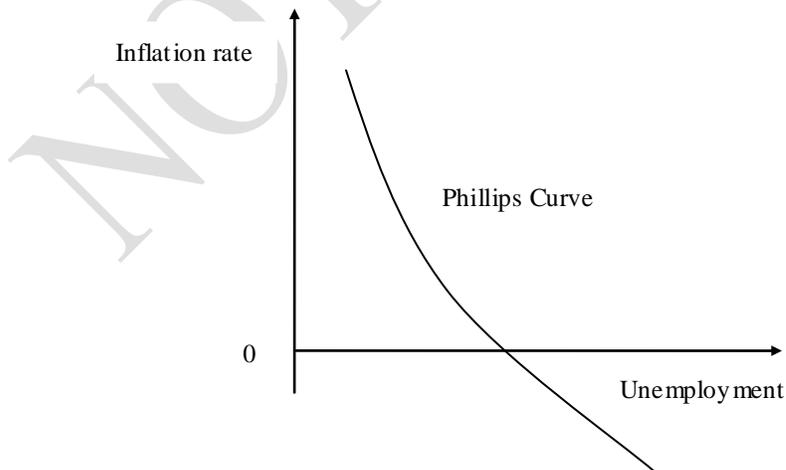
Cost-push inflation occurs where the costs of factors of production rise regardless of whether or not they are in short supply. This appears to be particularly the case with wages: workers anticipate inflation rates and demand wage increases to compensate, thus initiating a wage-price spiral.

(Alternatively) The graph below illustrates the cost-push inflation.



If a firm's costs increase they will react by increasing their prices and reducing production. This is represented by a shift to the left in the AS curve from AS_1 to AS_2 resulting in increase in the price level from P_1 to P_2 .

- (c) A.W. Phillips (1958) discovered a statistical relationship between unemployment and the rate of money wage inflation which implied that, in general, the rate of inflation fell as unemployment rose and vice versa. A curve known as Phillips curve can be drawn linking inflation and unemployment as follows:



The curve crosses the horizontal axis at a positive value for the unemployment rate. This means that zero inflation will be associated with some unemployment; it is not possible to achieve zero inflation and zero

unemployment at the same time. Furthermore, the shape of the curve means that the lower the level of unemployment, the higher the rate of increase in inflation.

(a) **Two** undesirable consequences of inflation are:

- (i) ***Redistribution effects.*** Different income groups are likely to be affected differently; for instance, those on fixed incomes will have their purchasing power reduced.
- (ii) ***The effect on the balance of payments.*** High inflation may make exports less competitive and depending upon the price elasticity of demand, the effect could be a deficit on the balance of payments.

8. (a) Free-floating exchange rate is the form of exchange rate left to the free play of market forces and there is no official financing at all. There is no need for government to hold any official reserves, because it will not want to use them. This is however, theoretical.

Rigidly fixed exchange rate system means that the government of every country in the international monetary system must use its official reserves to create an exact match between supply and demand for its currency in the foreign exchange market, in order to keep the exchange rate unchanged. Using the official reserves will therefore cancel out a surplus or deficit on the current account and non-official capital transitions in their balance of payment.

(b) The **four** factors that tend to influence exchange rates include:

- (i) ***Natural resources of the country.*** A country that is rich in natural resources should benefit not only from a net surplus on its current account but also from long term capital investment from overseas investors. Such a country's currency should therefore be strong in the foreign exchange market.
- (ii) ***The political stability of a country.*** A country with stable political or economic status is likely to have strong investment hence strong currency.
- (iii) ***Government policies.*** Some government policies such as exchange controls and import controls tend to weaken a country's currency.
- (iv) ***Speculation by traders.*** When a currency is expected to depreciate, debtors who owe money in that currency will pay their debts more slowly while those who owe in a currency that is expected to appreciate will pay more quickly. These 'leads' and 'lags' add to

the speculative pressure on currencies by altering supply and demand.

- (c) (i) Under the auspices of the central bank, devaluation lowers the external value of a country's currency while revaluation raises the external value of the currency against all other currencies that are part of the fixed exchange rate regime.
- (ii) Depreciation lowers the external value of a country's currency while appreciation raises the external value of the currency against other currencies under floating exchange rate system.
- (d) The **two** adverse economic effects from depreciation of the Malawi Kwacha are:
- (i) *It tends to be inflationary.* Depreciation of the Kwacha makes imports become more expensive (since the price elasticity of demand for imports is generally inelastic) leading to imported cost-push inflation.
- (ii) *It worsens the BOP deficit.* Since our price elasticity of demand to import, particularly of raw materials, is inelastic, while our export base is negligible, depreciation tends to worsen the BOP deficit as we continue to import more at higher prices and export less at lower prices.

9. (a) The **four** functions of taxation are:
- (i) To raise revenue for the government.
 - (ii) To discourage certain activities regarded as undesirable.
 - (iii) To distribute wealth.
 - (iv) To protect industries from foreign competition.
- (b) Progressiveness of income tax in Malawi:
- (i) Progressive income tax takes a higher proportion of income in tax as income rises.
- (ii) The **three** advantages of progressive income tax are:
- The tax is levied according to the ability of the individual to pay.
 - Progressive tax enables a government to redistribute wealth from the rich to the poor.
 - It helps to counterbalance regressive tax, such as indirect taxes, and this makes the tax system as a whole more fair.

Three disadvantages of progressive tax are:

- Higher income taxes on extra earnings will deter individuals from working harder since the money advantages would not justify the effort.
- Entrepreneurs may be reluctant to develop new companies since the after-tax profits would not be worth the risks involved in undertaking new investments.
- Many skilled workers might leave the country and look for employment in countries where they can earn more money.

(c) The Malawi Government borrowing:

- (i) National debt is the amount of debt owed by the central government of a country to its national or foreign creditors.
- (ii) **Three** advantages that may accrue to Malawi if it were to reduce its outstanding national debt are:
 - The government's budgetary position would improve due to reduced costs of debt servicing because of the reduced volume of national debt.
 - If the government reduces or ceases to borrow from the financial markets, the demand for loanable funds in the economy will decline and this could lower interest rates. This may encourage private investment in the economy to the extent that investment is sensitive to interest rates.
 - The government's improved financial position might now allow it to reduce the burden of taxation in the economy, and lower taxes might spur initiative, hard work and enterprise in the economy.

END