STRICTLY CONFIDENTIAL

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN MALAWI

2015 EXAMINATIONS

ACCOUNTING TECHNICIAN PROGRAMME

PAPER TC5: ECONOMICS

WEDNESDAY 9 DECEMBER 2015 **TIME ALLOWED : 3 HOURS**
2.00PM - 5.00 PM

SUGGESTED SOLUTIONS

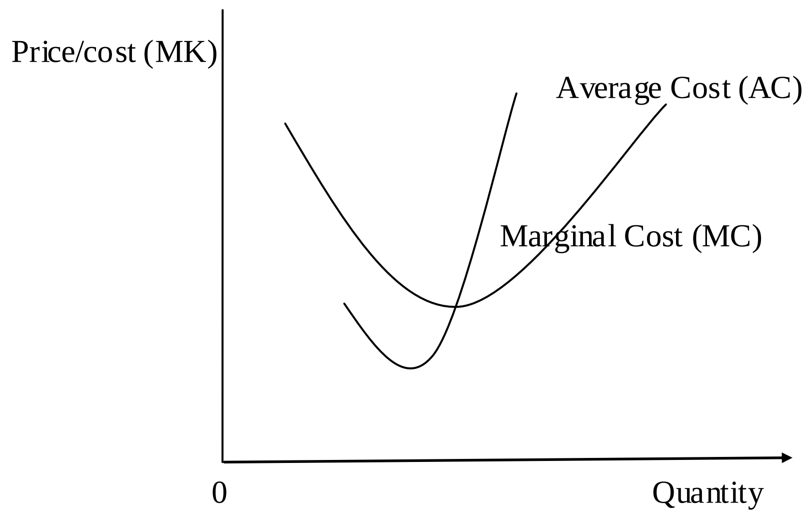
SECTION A

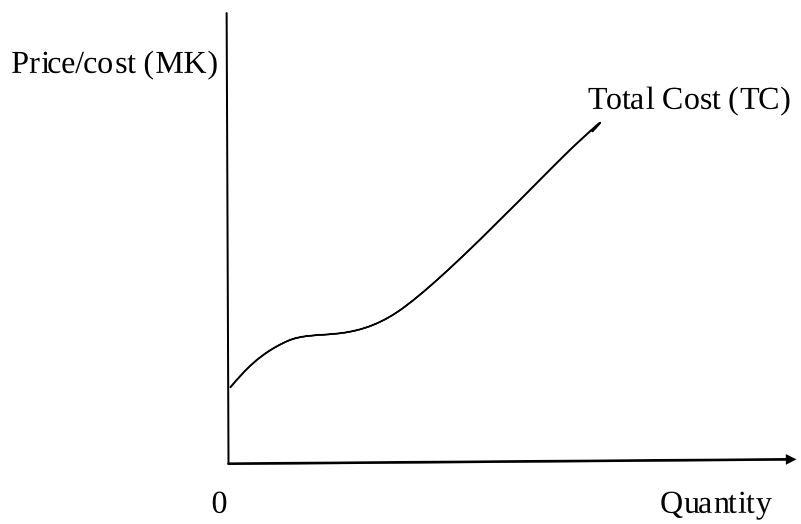
Answer two questions only from this section

1. (a) Deriving the average and marginal costs

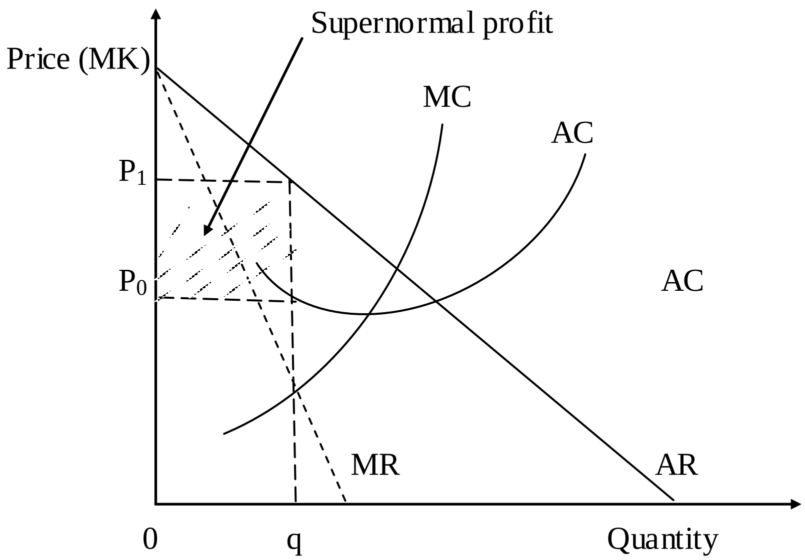
Units of output K	Total cost K	Average cost K	Marginal cost K
1	10	10	10
2	15	7.5	5
3	18	6	3
4	24	6	6
5	35	7	11
6	48	8	13

(b) (i) Typical characteristic graphs of average cost, marginal cost and the total cost.



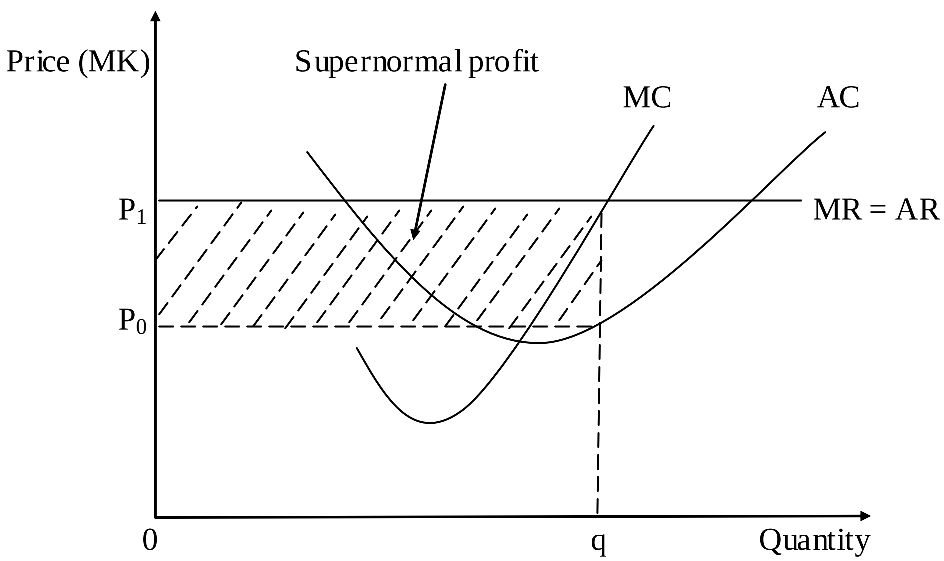


(b) (ii) Clearly labeling diagrams showing profit maximizing firms operating under perfect competition and monopolistic competition in the short run.



Monopolistic competitive firm in the short run making supernormal profit

MC = Marginal Cost
AC = Average Cost
MR = Marginal Revenue
AR = Average Revenue



Perfect competitive firm in the short run making supernormal profit

MC = Marginal Cost
AC = Average Cost
MR = Marginal Revenue
AR = Average Revenue

2. (a) Defining the production possibility curve:

The production possibility curve is a curve sowing the maximum combinations of quantities of commodities, which may be produced from a given level of resources.

(b) **Two** reasons why the production possibility curve is important:

(i) It shows the scarcity of resources and the impact that this has on output of various commodities.

(ii) It also illustrates the need to make a choice about what to produce, when it is not possible to have everything.

(c) **Four** economic changes that would lead to a rightward shift in the production possibility curve.

(i) Increase labour force.

(ii) Improvements in methods of production like use of machinery.

(iii) Discovery of new natural resources.

(iv) Better methods of working.

Note: Other points may be considered

(d) **Three** disadvantages of a free market system:

(i) Some vital resources cannot be provided by the private enterprise.

(ii) Some undesirable and harmful products can be produced.

(iii) There is inequitable distribution of goods and services (uneven distribution).

Note: Other points may be considered

(e) State and explain **three** basic questions of resource allocation decisions.

(i) What goods and services will be produced?

In a market economy this will depend on what consumers will want to buy, and what they will pay for each product or service. The decisions of what will be produced relate to demand and supply.

(ii) How will these goods and services be produced?

The producers or suppliers of goods and services might be small companies, large companies, state owned enterprises or government itself. The choice about who will produce the goods and services will depend on the cost of resources and efficiency of resource utilisation.

(iii) To whom the goods and services will be distributed?

Some goods and services are distributed for free by the government (state) e.g. health care and education, but others are paid for. The distribution of goods and services will depend on the distribution of income and wealth in society. Some people have the financial resources to enjoy great quantities of goods and services of the highest quality.

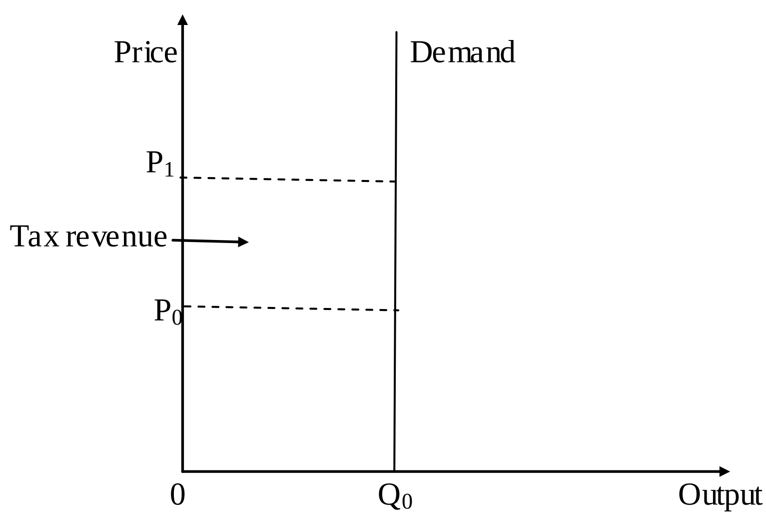
3. (a) Likely price elasticity of demand for salt in Malawi:

It is perfectly inelastic.

(b) Why I would be more willing to increase the price of salt:

Increase in price does not lead to a fall in demand and revenue.

(c) Explaining the effect on consumers and producers if the Malawi Government decided to levy value added tax on salt.



If the Government decided to levy value added tax price will rise from P_0 to P_1; quantity demanded and supplied will remain the same Q_0 P_0 is price before tax and P_1 is price after tax.

If the Government decided to levy value added tax on salt consumers will pay more i.e. price P_0 plus the tax $P_1 - P_0$, thus the consumer will bear the whole tax burden because salt has a perfectly inelastic demand as for perfectly inelastic products the demand does not change due to a change in price.

For the producer, his revenue will remain the same as before government decided to levy value added tax on salt. Thus the tax will affect only the consumer.

(d) Stating and explaining three factors that influence the price elasticity of supply of a product:

(i) Excess/spare capacity: if there is spare capacity suppliers will be able to respond quickly to an increase in price and therefore supply will be elastic. If producers are operating at or near full capacity, supply will be elastic, at least until capacity can be varied.

(ii) The number of supplies: the more suppliers there are in the market, the more elastic market supply will be.

(iii) The time it takes to increase capacity: in certain industries, expansion takes a long time. Once such industries are operating at full capacity, therefore supply will be inelastic.

Note: Other points may be considered

(e) The difference between Consumer Surplus and Producer Surplus

Consumer surplus is the difference between the price the consumer is willing to pay and the price the consumer actually pays, while producer surplus is the difference between the price producers are willing to supply at and the price they actually receive.

SECTION B

Answer three questions only from this section

4. (a) Explaining **two** factors that determine how much individual consumers consume and save.

(i) Income: The higher the income the higher is the consumption.

(ii) Availability and cost of credit: The easier and cheaper it is to borrow, the more people are likely to spend. When people spend more than they earn they are said to dis-saving.

(b) (i) Calculating aggregate demand AD, and savings S at each income level.

Y	C	I	AD = C+I	S=Y-C
0	100	100	200	-100
500	520	100	620	-20
600	600	100	700	0
900	840	100	940	60
1,100	1,000	100	1,100	100
1,500	1,300	100	1,400	200

(ii) Meaning of the term autonomous consumption.

A fixed amount of money every period which is independent of the level of income also known as exogenous expenditure.

(iii) At the level of income K1,100 calculating:

(1) The average propensity to consume (APC)
APC = C÷Y = 1,100 = 0.91

(2) The average propensity to save (APS)
APS = S÷Y = 100÷1,100 = 0.09

(iv) The marginal propensity to consume (MPC) when the income level changes from 500 to 600 units.

$$MPC = \Delta C \div \Delta Y = 80 \div 100 = 0.8$$

(v) Calculating the marginal propensity to save (MPS) and the multiplier.

C = 12+0.4Y
MPC = 0.4

MPC + MPS = 1
MPS = 1 – MPC
MPS = 1 – 0.4
MPS = 0.6

Multiplier = 1÷MPS
= 1÷0.6
= 1.67

5. (a) Defining fiscal policy

Fiscal policy is government action to collect money and spend money with the purpose of influencing the conditions of the national economy.

(b) **Two** main ways of reducing the size of Public Sector Borrowing Requirement (PSBR).

(i) Government must reduce its expenditure.

(ii) Government must raise its income from taxation.

(c) Supply side economics

Supply side economics is concerned with formulation of economic policies that will advocate improving the supply of goods and services rather than measures that affect aggregate demand.

(d) **Five** main objectives of supply side policies:

(i) Improving labour productivity.

(ii) Increasing the competition between firms to encourage efficiency.

(iii) Increasing investment by firms.

(iv) Increasing people's incentive to work.

(iv) Improving the geographical and occupational mobility of labour.

(e) **Five** causes of underdevelopment:

(i) Poverty

(ii) Unemployment

(iii) Inflation

(iv) Budget deficits .

(v) Balance of payments.

(f) **Two** costs of unemployment:

(i) The economic cost; this is the loss of output which could have been produced had the unemployed been in employment.

(ii) The cost of the ex-chequer (Government); This is the cost of paying benefits to the unemployed, social security and the opportunity cost of the taxes unemployed would have paid.

6. (a) Defining the term foreign exchange rate.

Foreign exchange rate at which one country's currency can be traded for another country's currency. It is the price of one currency in-terms of another.

(b) **Four** factors that affect exchange rates:

(i) Speculation by traders.

(ii) The political stability of the country.

(iii) Government policies.

(iv) Natural resources of a country.

(c) **Two** adverse economic effects arising from the depreciation of the Malawi Kwacha.

(i) It worsens the balance of payments.

(ii) It causes inflation.

(d) Defining terms of trade:

Terms of trade refers to the rate at which a country can exchange its exports for imports.

(e) **Two** causes of a decrease in terms of trade.

(i) Currency depreciation (or devaluation).

(ii) Relative low domestic inflation.

(f) **Two** advantages of a fixed exchange rate system.

(i) Makes international trade more stable, it removes uncertainty of what the exchange is going to be.

(ii) Gives room for speculation in the market and this cannot lead to fluctuations in the fixed exchange rate systems.

(g) Defining special drawing rights.

This is a unit of account that was created by International Monetary Fund (IMF) in 1969 and is defined in terms of a basket of five major currencies used in international trade and finance.

Or

It is an international reserve asset used to settle international debts by transferring governments accounts held at the IMF.

(h) Meaning of the term globalization.

Globalisation describes a process by which regional economies, societies, and cultures have become integrated through a global network of communication, transportation and trade.

(i) **Three** negative effects of globalization:

(i) Developed nations have outsourced manufacturing and white collar jobs, that means less jobs for their people.

(ii) Globalization has led to exploitation of labour. Prisoners and child workers are used to work in inhumane conditions.

(iii) Job security. Earlier people had stable, permanent jobs and now people live in constant fear of losing their jobs to competition. Increased job competition has led to reduction in wages and consequently lower standards of living.

7. (a) **Two** broad schools of thought about monetary theory.

(i) The old quantity theory of money developed by Irving Fisher in 1911 and Keynesian theory (1936).

(ii) The new quantity theory of money developed by Milton Friedman in 1956.

(b) Naming and explaining **four** main factors that contribute to money supply growth.

(i) Government borrowing: the amount of money that government borrows each year is called Public Sector Borrowing Requirement (PSBR) and the higher the government borrowing the more is the increase in the money supply.

(ii) The type of the lender from who government borrows: Money supply can grow if government borrows from banks than from non-bank sector since banks have the ability to create credit out of funds lend out to borrowers.

(iii) Bank lending: Bank lending increases the money supply.

(iv) Flows of money between a country and foreign traders/investors:
If a country pays more to foreign trades than what it receives from foreign traders/investors money supply will decrease.

(c) **Four** broad approaches a government can use to control the growth in money supply:

(i) Government should control or reduce size of the Public Sector Borrowing Requirement.

(ii) Repayment of loan should be financed as much as possible by borrowing from non-bank private sector.

(iii) Control the increase in bank lending by raising interest rates.

(iv) Control external and foreign currency items, for example, by keeping the balance of payments under control.

(d) Explaining **six** ways in which the government can influence the level of private investment.

(i) It can attempt to control interest rates, by reducing them in order to encourage higher volume of investments.

(ii) It can provide direct encouragement to investing firms, by offering investment grants perhaps directed at particular regions, or by providing tax incentives in form of tax allowances and tax holidays.

(iii) The government can try to encourage technological developments by financing research schemes of its own and also by entering research partnerships with private firms.

(iv) Government policy might be directed to influence volume of consumption. This is because consumption affects investment through the accelerator.

(v) The government can spend money itself, and higher the government spending might stimulate investment by private sector.

(vi) The government can develop and announce an economic policy for continued growth and then achieving policy targets.

E N D