**INSTITUTE OF BANKERS IN MALAWI**

**ECONOMIC ENVIRONMENT**

**(Diploma in Banking)**

**MAY, 2014 EXAMINATIONS**

**MODEL ANSWERS**

**SECTION A**

**QUESTION 1**

1. Trend economic growth refers to the smooth path of long-run output i.e. the average of the peak points and trough points in different economic cycles 1

* growth of working population: which affects the number of people looking for paid jobs 2
* growth of capital stock: which is driven by the level of investment 2
* growth of factor productivity: which is a measure of gains in factor efficiency 2
* improvements in technology: which reduces real cost of production and shifts the production possibility frontier 2

X

a

b

x

c

Y

2

* abc is the production possibility frontier (PPF) 1
* point ‘x’ within the PPF is a point of unemployment 1
* more resources if employed will increase production of X or Y or both 1
* therefore, points on the PPF depict full employment 1

**QUESTION 2**

Factors that undermine the use of per capita income as measure of standard of living are (any five):

* Regional variations in income and spending: national income figure may not explain differences in employment and social/economic deprivation 5
* Distribution of wealth: rising national prosperity may be associated with rising relative poverty if the created wealth is concentrated in a few hands 5
* Externalities: GDP figures do not indicate associated negative externalities and the quality of the products, which may have an impact on economic welfare 5
* Leisure and labour: Rising national income may happen at the expense of leisure 5
* Balance between consumption and investment: we need economic growth that enables improved consumption while preserving resources for future economic development 5
* The black market: GDP may understate the extent of economic activity if the informal (non-monetised) sector is significant and growing 5

**QUESTION 3**

The differences in the terms are:

1. Labour and Entrepreneur: Labour is human resource employed in the production process while Entrepreneur is that special kind of human resource that take risk to organise other factor inputs to start to produce 3
2. Fixed Capital and Working Capital: Fixed Capital are goods that are meant to increase productive potential in future e.g. machinery whereas Working Capital are goods ready for consumption or to be used to produce final goods 3
3. Privatisation and De-regulation: Privatisation is a process whereby government-owned enterprises change ownership to become private-owned. De-regulation is a process whereby barriers to market entry are removed to foster competition 3
4. GDP and GNP: GDP is total output produced within the boundaries of a given economy while GNP is total output of nationals from within and outside the boundaries of the applicable economy 3
5. Money and Cash: Cash constitutes only coins and bank notes while Money is broader as it includes other instruments e.g. bank account balances 3

**QUESTION 4**

1. The five functions of the monetary authority in Malawi are:

* issuing currency 2
* banker and regulator of commercial banks 2
* banker of government 2
* custodian of bullion (gold) and foreign exchange reserves 2
* custodian of monetary policy 2

1. Mathematically, the removal of the currency in vaults meant banks needed to fill in the gap in order to comply with the reserving requirement. Effectively this meant the same as increasing the liquidity reserve ratio (LRR). Therefore, the cost of funding for banks had gone up (tightening of monetary policy) which would force banks to raise interest rates to reduce lending and/or attract more deposits (liquidity). 5

**SECTION B**

**QUESTION 5**

Graph 1 (equal elasticity) 3 Graph 2 (inelastic demand) 5

Price

Price

St

St

x

y w

z

a

b

c

Pt

P0

P1

S0

S0

Pt

P0

P1

D0

D0

Quantity

Quantity

Qt Q0

Qt Q0

From Graph 1:

* P0,Q0 are initial prices/quantities (without tax) in market where supply is S0 and demand D0
* When a tax is imposed, the price rises to Pt, leading to lower demand and therefore supply shifts to St 2
* With equal elasticity of demand and supply, the tax revenue Pt.a.c.P1 is made up of two portions contributed by the consumer (Pt.a.b.P0) and producer (P0.b.c.P1) 2
* The two tax blocks are forgone consumer surplus (area above P0 but below the demand curve) and producer surplus (area below P0 and below the demand curve) 2

From Graph 2:

* Before tax, the area Pt.x.w.P0 is the lower portion of consumer surplus 2
* After tax, the tax revenue becomes Pt.x.z.P1 which is almost the same size as Pt.x.w.P0 2
* This implies that almost all the tax has been paid from the consumer surplus (except a very small portion, P0.y.z.P1, taken from producer surplus) 2

**QUESTION 6**

(a)

* Change in the number of firms demanding labour 2
* Change in price of product produced – which changes the marginal revenue product (MRP) – will alter the quantity of labour demanded at each wage rate 2
* Change in marginal physical product (MPP), which will change the MRP (=MPP\*P) 2
* Change in prices for other factor inputs 2

(b)

* Robert Solow, a neo-classical, attempted to model long-term growth by assuming that countries can use resources efficiently and that the principle of diminishing returns applies 3
* Increasing capital relative to labour will make the later more productive hence create economic growth 3
* Poor countries (those with less capital per person) will experience faster economic growth because each increase in capital will have higher impact (return) than the rich countries 3
* Although there is diminishing returns to capital, it is possible to extend the life of economic growth the “steady government” point by introducing technology advancement 3

**QUESTION 7**

1. Fiscal policy describes the actions of government in setting the level of public spending and how that expenditure is funded 2
2. Three facts in defence of morality of taxation, as follows:

* social justice – where tax from the wealthy is used to uplift the poor 1
* defend liberty – taxes used to maintain political/economic freedom 1
* maintenance of economic infrastructure – used to create the taxed wealth 1

1. The ills of the plunder of public funds at Capital Hill (‘Cash-gate’) are: (any five)

* loss of public trust – which may lead to tax avoidance and evasion 3
* forgone public goods – opportunity cost as less resources are available for providing public goods and services 3
* social and political tension – taxpayers and their defenders become angry at government 3
* loss of donor confidence, leading to withdrawal/withholding of grants/aid 3
* reduction of public spending through budget (in accordance with smaller resource envelope)

3

* government projects impacted negatively 3
* donor are a source of foreign exchange – so pressure on Kwacha to depreciate 3
* loss of investor confidence – they may fear tax increases and lack of operative public infrastructure 3

**QUESTION 8**

The four instruments used by authorities in Malawi to enforce monetary control are:-

* Accommodation policy – as lender of last resort, the central bank allows liquidity-stressed banks to borrow but at a rate that is usually punitive. This sort of discourages lending (money creation). 5
* OMOs (open market operations) – this is done through the sale of local currency financial instruments e.g. Treasury bills or foreign exchange. Sale of Treasury bills withdraws money from the financial system while purchase achieves the opposite. As for foreign currency, purchases inject Kwacha liquidity while sale mops up Kwacha. 5
* Public debt management – the explanation is similar in effect to the act of trading Treasury bills. The amount of Treasury bills to be sold depends on fiscal gap (difference between public revenue and spending). So, prudent spending helps reduce need to issue Treasury bills and therefore monetary expansion. 5
* Reserve asset requirements – here banks are required to hold a certain percentage of the value of total liabilities to the public in the form of approved (eligible) liquid assets. This has the effect of limiting resources available for banks to lend out and create money. An increase in the requirement means increased monetary control and vice versa. 5

**– END OF MODEL ANSWERS –**