THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKIS

**EXAMINERS' COMMENTS**

| SUBJECT | SESSION |
|---|---|
| Introduction to Economics and Finance | Foundation – Autumn 2007 |

General:

The overall performance of the candidates was poor. Most of the time the answers were either incomplete or too lengthy with a tendency to disclose all the facts about the topic whether relevant or irrelevant.

Question-wise comments are given hereunder:

Q.1 (a) The concept of marginal utility and its application to (i) normal goods and (ii) money, was tested. A large number of candidates were able to obtain full marks. Most of the candidates were able to explain clearly that marginal utility decreases with the use of every successive unit of normal goods. Similarly, most of the candidates were able to state that marginal utility does not diminish in the case of money. However, very few of them went on further to explain that money is used to acquire most of the human needs which are unlimited and hence marginal utility of money does not diminish.

Some of the candidates misunderstood the question and ended up explaining the relationship between income and marginal utility which was not required.

(b) The concepts of equi-marginal utility refers to a situation whereby the consumer substitutes the more useful things for less useful things till the marginal utility for all goods (in all directions) becomes equal. Most candidates explained the concept correctly with appropriately example. However, some of them mixed it up with the concept of Diminishing Marginal Rate of Substitution.

Q.2 (a) Very few of the students could identify more than one or two factors responsible for diseconomies of scale such as reluctance to change; over production, lack/difficulty of supervision, lack of personal/direct interest, dependence on foreign markets etc. Some of the students explained economies of scale instead of dis-economics of scale.

(b) The students were generally able to explain the relationship an Marginal Revenue, Average Revenue and Price under perfect competitio However, most of them, were unable to give the reasons thereof and lost most of the marks. In fact they were required to explain that in the presence of a large number of buyers and sellers the supply of a firm is insignificant and it cannot influence the price in the market. Therefore it has to sell its goods at market price. As a result, each additional unit fetches the same revenue and that is why MR=AR=P.

Q.3 This question on inflationary and deflationary gaps was the worst attempted. About 25% of the students failed to attempt it altogether. Only around one percent were able to secure full marks. Some gave the diagrams only with no explanation at all, whereas others only gave the explanation without any diagrams. Nearly all candidates failed to label the diagrams correctly. Some students got confused between inflationary and deflationary gaps and interchanged the diagrams.

Q.4 (a) (i) While explaining the purchasing power theory the students were generally able to clarify that under this theory the exchange rate is related to the purchasing power of the respective currencies. Most of them explained it practically with the help of an example also. However, the finer points such as (a) the theory holds good in the long run only (b) practically the general price level in the two countries is not relevant only the price level of internally traded goods is relevant; were mentioned by very few of the students.

(ii) In case of demand and supply theory most examinees explained that under this theory exchange rate is determined at the level where demand and supply for the currency becomes equal. However, most of them did not explain how demand or supply is created and what happens if demand is in excess of supply and vice versa.

(b) Even though the question specifically asked for arguments in favour of the floating exchange rate policy, a large number of students simply explained what the floating exchange rate policy was, instead of answering the actual question. Many students refrained from attempting the question altogether but many of them performed well also and clearly identified the advantages such as independent economic policies, rectification of dis-equilibrium in balance of payment through exchange rate adjustment etc.

Q.5 (a) Majority of the students were able to explain the process of credit creation by commercial banks with the help of an example. Many students extended the example to a very large number of steps and wasted lot of time. The good students were clear enough to give the formula i.e.

*Maximum Deposit = (Initial Deposit – Reserve) ÷ Reserve Percentage*

A vast majority wrote the formula for the savings multiplier (S=a/1-r) instead of the money multiplier. Some students got confused and started explaining the different types of loans extended by the banks.

(b) In this question, most of the candidates performed well and correctly identified how credit creation is controlled by the central bank such as through changes in the reserve ratio, bank rate policy, open market operations, credit rationing, moral persuasion and credit regulations etc.

Q.6 (a) This was an easy question and many students got good marks. Most of the students recognized optimum utilization of resources, social security, rapid economic development and social justice as the main merits of socialist system. Some students were really confused and started explaining the characteristics of a socialistic economy without referring to its advantage.

(b) This proved to be an easy question for the students probably because the term “opportunity cost” is quiet self explanatory specially for the students with commerce back ground.

Q.7 Identification of factors of demand proved easy for the students but around 35% of the examinees only identified the factors without giving any explanation and lost precious marks. For example, change in liquidity preference was identified as a factor which affects demand but it was not explained that if liquidity preference increases, consumer would prefer to keep cash and refrain from buying goods and hence the demand would decrease. Many students also wasted time in discussing the law of demand which was not at all required.

Q.8 Although the question was simple and straightforward but somehow it proved to be one of the worst attempted, probably because of lack of preparation. Very few of the examinees were able to identify the five basic assumptions of marginal productivity theory i.e.

(i) Identical efficiency of all units of the same factor of production.
(ii) Each factor of production being perfect substitute for the other.
(iii) Perfect competition in the market.
(iv) Perfect mobility of all factors of production.
(v) Operation of the law of diminishing returns.

Some of the candidates confused it with the law of diminishing marginal product and marginal utility.

Q.9 The performance in this question was highly unsatisfactory. Most of the candidates were of the opinion that the main objective of WTO is to help out developing countries through loans and assistance. The main activities such as determination of rules of trade among nations, settling disputes among trading nations and protection of individuals and government from sudden changes in the trade policy by the host nation, were mentioned by very good students only. In some answer scripts two full pages were written without covering the relevant points.

Q.10 (a) Majority of the students easily recognized resource allocation, inc... distribution, full employment and economic stability as the main objective... of fiscal policy. Some of them started explaining expenditure patterns, revenue raising and PSDR, which was not required.

(b) This part of the question required a brief explanation of the fiscal measures the government takes to increase the level of employment. Increasing the level of expenditure was correctly identified by most students, as one of the steps that the government may take in this regard but they could not explain how it affects the level of employment. Even fewer candidates were able to explain the link between a reduction in taxes on profits and increase in employment.

**(THE END)**