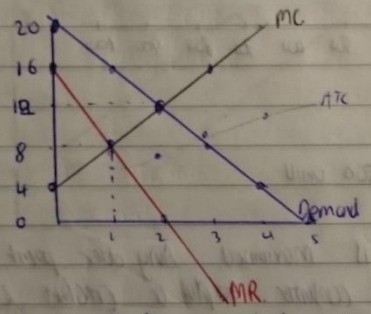
Economics 2011

Q1

Price	Q demanded	Total revenue	marginal revenue	Total cost	Marginal cost	TR-TC Profit
20	0	0		2		
			16		4	-2
16	1	16		6		
			8		8	10
12	2	24		14		
			0		12	10
8	3	24		26		
			-8		16	-2
4	4	16		42		
			-16		20	-26
0	5	0		62		-62

iii. Profit is maximum when MR = MC



1 unit profit = 10

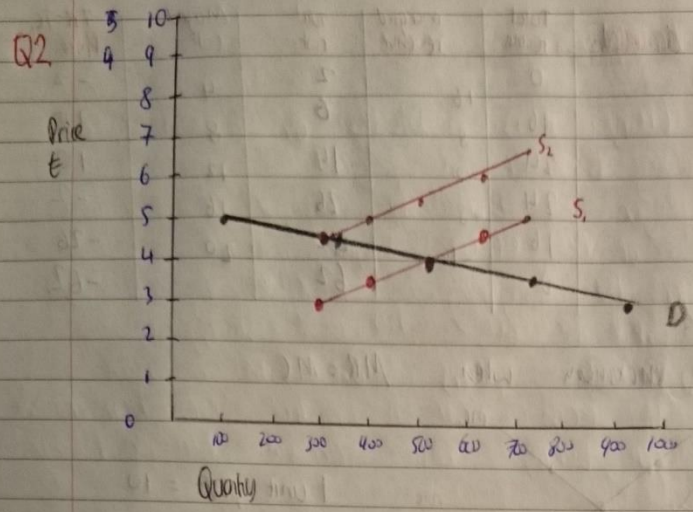
iv. - Produce a smaller output at a higher price
- Monopoly inefficient
- Smaller output and higher price drive a wedge between marginal social benefit and marginal social cost creating a deadweight loss
- Consumer surplus shrink

v. Consumer Surplus: the monetary gain obtained by consumers because they are able to purchase a product that is less than the highest price that they would be willing to pay
= ½ 8.1 = 4 : consumer surplus

Producer surplus - amount that producers benefit by selling at a market price that is higher than the least they would be willing to sell for.

Deadweight loss - loss of economic efficiency occurs when equilibrium for a good or service is not optimal - Cause - monopoly

Q2.



i. Price is €4, quantity is 500 units

ii. Yes it is. Consumer surplus is maximised. Any other point would create a loss in consumer surplus & creation of a deadweight loss

iii. When tax is put on producer price is 450 and quantity is 300
Buyer pays 50cent tax, producer 0€ euro

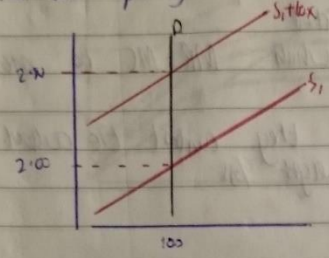
iv. Taxes are inefficient, they create deadweight loss, mean a loss in consumer surplus and benefits

v. It is the analysis of the effect of a particular tax on the distribution of economic welfare. Tax incidence is said to 'fall' upon the group that ultimately bears the burden of the tax. Key concept is that tax burden does not depend on where the revenue collected but on the price elasticity of supply and demand

3

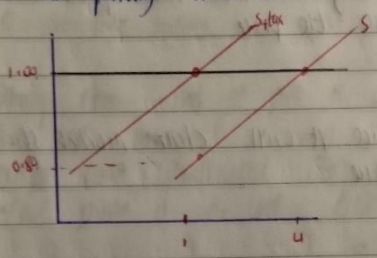
ECON 2011

Q2 Tax with perfectly inelastic demand



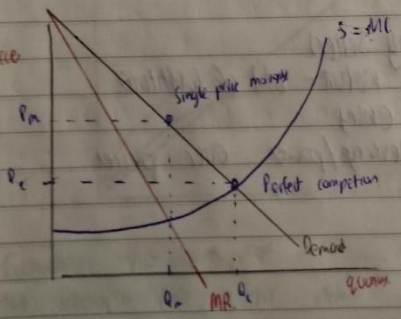
- Demand perfectly inelastic
- No tax Q=100 P=2.00
- Tax of 50cent imposed
- Decreased supply ⇒ left shift
- Price rises to 2.50 but Q remains the same. Buyer pays all tax

Tax with perfectly elastic demand



- Demand perfectly elastic
- Price = 1.00 Q = 4
- tax of 2cent.
- Decreased supply
- P = 1.00 for Q = 1
- Seller pays all the tax

Q3



- Competitive market produce quantity Q_c at price P_c
- Single price Monopoly produce quantity Q_m at price P_m where MR = MC
- Monopoly produces smaller output and charges higher price
- Monopoly is inefficient because of deadweight loss created
- In competitive equilibrium Q_c is produced by the firm at price P_c

Monopoly → only one producer/seller for a product
- entry into this market restricted
- Produce the amount at which MR = MC to maximise profit.
- They control the price as they control the output
- Inefficient → creates deadweight loss
- No competition

Oligopoly (Monopolistic competition) - only a few firms make up the industry
- The select group has control over the price
- High barriers to entry
- If one Prices interdependent
- If one Firm drops price it will claim market share
- Others must also drop price
- Efficient, Competitive

Perfect Competition -
- Many buyers and many sellers
- Many products similar in nature - alot of substitutes
- few or no barriers to entry
- Companies have little leverage/power over prices
- Competitive efficient

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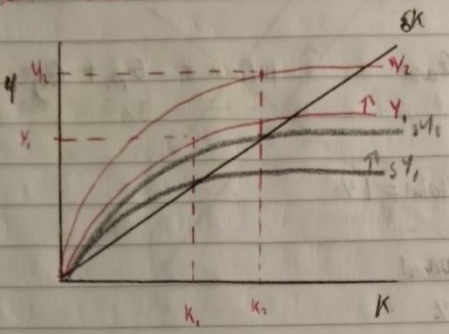
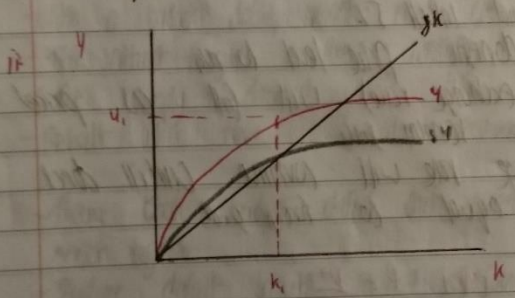
Q4 A5.



Formula $Y = A k^{\alpha} L^{1-\alpha}$

A = total factor productivity k = capital L = labour

- Initially china was at point K_1 and GDP of Y_1
- But TFP increased having the effect of shifting the output curve upward and also sY (saving curve) upward
- New position is K_2 and GDP of Y_2



Formula $Y = Ak^{\alpha} L^{1-\alpha}$

- The situation arose from richer countries having better access to technology causing TFP to rise, thus increased output and saving
- Other countries may be growing as fast but the country with higher GDP have higher capital or labour force as indicated by the formula

Output is greater in these countries attributed to higher level of capital / labour

4 bi. $G_{money} = G_{price} + G_{output}$ inflation = $G_{gdp} + G_{vy}$

$G_{gdp} = g_m - G_y$

3% - 2%

= 1% inflation = 1%

ii inflation + real rate = nominal

1% + 4% = 5%

To ensure savers get 4% interest without inflation eating away at it (1% still) they must compensate for this by adding back on the 1%

iii. Price of A = $\frac{£s}{\text{Exchange rate}}$

- Inflation is 1% and nominal interest 5%
- Inflation causes domestic price level to rise
- PPP predicts e (exchange rate) will fall as prices in other countries remain stable
- Depreciation of exchange rate will continue until dom. price level is equal to foreign level

e will adjust until $P = \frac{P^*}{e}$

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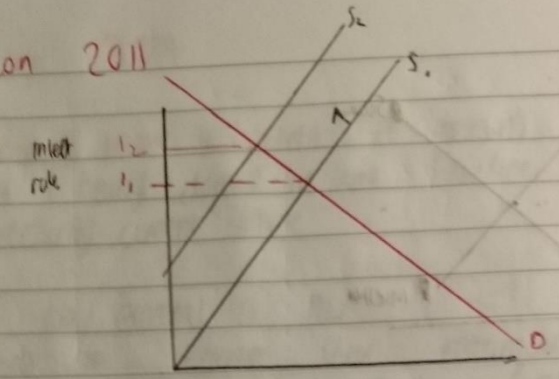
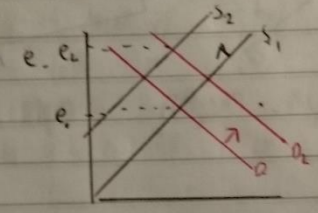
Q 5A



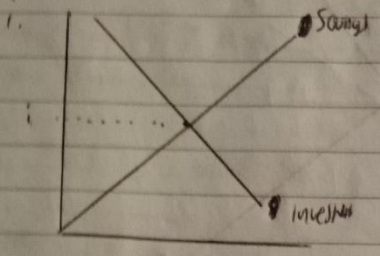
i. With a budget deficit, the supply of savings decreased (shifts left) with this decrease the interest rate increased from i_1 to i_2

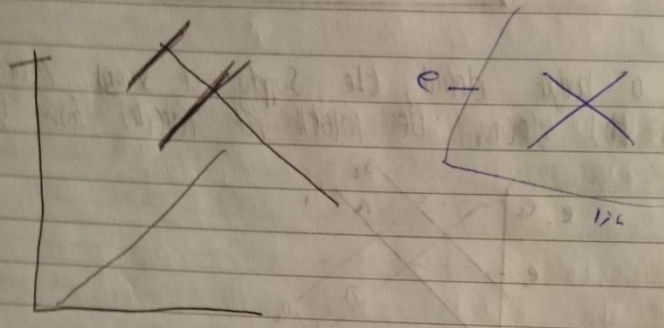


- with a budget deficit, interest rate are high in domestic economy
- this attract foreign investment, increasing demand of $
- the supply decreased with this increase in demand
- Result in new nominal exchange rate of e_2

iii - Theory that budget deficit and current account deficit occur together.
- Budget deficit results in fall of Savings
- Create higher interest rate because a lower supply of Savings
- Higher interest rate cause e to appreciate
- exchange rate strong → bad for trade from foreign market
- lead to current account deficit

5B





current account is already in deficit.

- Increase real rate even further
- Increase in investor inflow.
  appreciation of currency
- falls and become negative

When more needed in other country

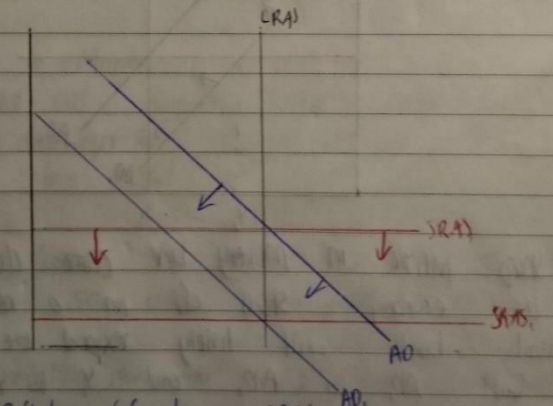
Econ 2011

Q6 i. Permanent income hypothesis: A person's consumption level today depends on all lifetime income - and not necessarily current income

A) the economy is now at its potential output people are earning their maximum income. Now consumption demand slowly falls as people smooth out their income

If price level is high today, people might expect it to fall in the future. For this reason they might postpone expenditure until the future, leading to a fall in aggregate demand today

ii The economy will always react to return ($Y = Y_n$) when $Y < Y_n$, price will fall and the SRAS curve will shift downward



Since AD shifted leftward, SRAS will drop over long run to form a new equilibrium with AD, SRAS, and LRAS

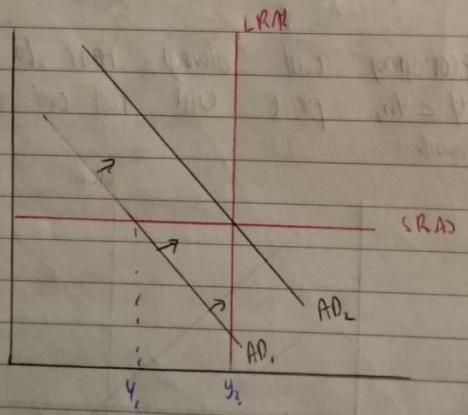
iii. Taylor rule: $i^* = y + \pi + 0.5(\pi - \pi^*) + 0.5(y - y_n)$

y = constant π = inflation π^* = inflation target

If output is below potential ($y - y_n < 0$), the Taylor rule dictates that the central bank should lower interest rates: by reducing the cost of borrowing, aggregate demand should rise to clear the output gap.

Taylor rule: monetary policy rule that stipulates how much the central bank should change its nominal interest rate in response to changes in inflation, output or other economic conditions

v.



- The sharp increase in money base came during the recession
- If the economy starts off in a recession, the central bank will likely expand the money supply to shift AD_1 to AD_2 and Y_1 to Y_2
- It is supposed to stimulate a higher AD