CERTIFIED PUBLIC ACCOUNTANT

FOUNDATION LEVEL 2 EXAMINATION

F 2.2 : ECONOMICS AND THE BUSINESS ENVIRONMENT

WEDNESDAY : 11 JUNE 2014

INSTRUCTIONS:

1. **Time Allowed: 3 hours 15 minutes** (15 minutes reading and 3 hours writing).

2. This examination has **seven** questions and only **five** questions are to be attempted.

3. Marks allocated to each question are shown at the end of the question.

4. Show all your workings

QUESTION ONE

(a) In a certain economy the marginal propensity to save is 0.2 and the autonomous consumption equals 400.

   (i) Formulate the consumption function. **(3 Marks)**

   (ii) If the Government's expenditures were increased by 50% what would be resultant change in National Income. **(3 Marks)**

(b) The demand and supply schedules for carrots in a certain market are given below :

Price per ton	Quantity demanded per month	Quantity supplied per month
Frw. "000"	(Thousands of tons)	(Thousands of tons)
2	110.0	50.0
4	90.0	46.0
8	67.5	100.0
10	62.5	115.0
12	60.0	122.5

   Determine the equilibrium quantity and price by graphical method. **(8 Marks)**

(c) Explain how the concept of elasticity guides decisions in the following situations :

   (i) Government's tax policy on household consumption. **(2 Marks)**

   (ii) Devaluation policy to encourage exports and discourage imports. **(2 Marks)**

   (iii) Price discrimination by monopolist. **(2 Marks)**

(Total: 20 Marks)

QUESTION TWO

(a) Using indifferent curve analysis illustrate how a household's equilibrium point is attained **(5 Marks)**

(b) By focusing on an inferior good, use the indifference curve analysis to demonstrate and explain the income and substitution effects. **(10 Marks)**

(c) Based on the analysis in (b) above, distinguish between an inferior good and a giffen good. **(5 Marks)**

(Total: 20 Marks)

QUESTION THREE

(a) Explain the terms "absolute and comparative advantage" in the context of international trade. **(6 Marks)**

(b) Discuss the possible gains that may be generated by international trade. **(6 Marks)**

(c) Explain the ways in which countries could place barriers against international trade. **(8 Marks)**

(Total: 20 Marks)

QUESTION FOUR

(a) State the law of diminishing returns as applied to production functions. **(3 Marks)**

(b) Illustrate and explain the three stages associated with the law of variable proportions. **(9 Marks)**

(c) The table below represents a production function for a commodity X where capital is fixed and labour is variable :

Quantity of labour	Total Physical product (tons of X)
0	0
1	15
2	34
3	48
4	60
5	62

Using the data in the table, plot the marginal product for labour. **(8 Marks)**

(Total: 20 Marks)

QUESTION FIVE

You have been hired as a consultant by a firm producing bread to advise on a price strategy that would enable the firm to maximize profits. The firm is a monopolist which sells in two distinct markets, one of which is completely sealed off from the other.

As part of the analysis, you establish that the total demand for the firm's output is given by the following equation:

$Q = 50 – 5.0P$

And the demand for the firm's output in the two markets is given by the following equations:

$Q_1 = 32 – 0.4 P_1$; and

$Q_2 = 18 – 0.1P_2$

Where Q = total output

P = Price

Q_1 = Output sold in market 1

Q_2 = Output sold in market 2

P_1 = Price charged in market 1

P_2 = Price charged in market 2

The total cost of production is given by $C = 50 + 40Q$

Where C = total cost of producing a unit of bread.

Required:

(a) The total output that the firm must produce in order to maximize profits. **(3 Marks)**

(b) What price must be charged in each market in order to maximize profits? **(2 Marks)**

(c) How much profit would the firm earn if it sold the output at a single price? **(5 Marks)**

(d)   (i) The price elasticity of demand for the two markets at the equilibrium price quantity. **(5 Marks)**

(ii) Comment on how the price elasticity of demand may be used in making economic decisions.

(3 Marks)

(e)   Under what conditions is price discrimination possible? **(2 Marks)**

(Total: 20 Marks)

QUESTION SIX

(a) Assume the following information represents the National Income model of an 'Utopian' economy.

$$Y = C + I + G$$
$$C = a + b(Y - T)$$
$$T = d + tY$$
$$I = I_o$$
$$G = G_o$$

Where $a > O; O < b < 1$

$d > O; O < t < 1$

T = Taxes

I = Investment

G = Government Expenditure

(i) Explain the economic interpretation of the parameters a, b, d, and t. **(4 Marks)**

(ii) Find the equilibrium values of income consumption and taxes. **(8 Marks)**

(b)   Discuss the three approaches used in measuring the national income of a country and show why they give the same estimates. **(8 Marks)**

(Total: 20 Marks)

QUESTION SEVEN

(a) Explain how both fiscal and monetary policies are used to influence the performance of an economy.

(8 Marks)

(b) Discuss the factors which limit the effectiveness of monetary and fiscal policies in developing countries. **(6 Marks)**

(c) List and briefly explain the main determinants of the size of the economically active population of a country. **(6 Marks)**

(Total: 20 Marks)

End of question paper