LIVE: FINAL EXAM PREPARATION PAPER 2 10 NOVEMBER 2014

Lesson Description

In this lesson we:

- Work through selected examination questions covering:
  - Microeconomics
  - Contemporary Economic Issues

Exam Questions

Question 1

(Adapted from EC Sept 2014, Paper 2, Question 2.1)

Answer the following questions.

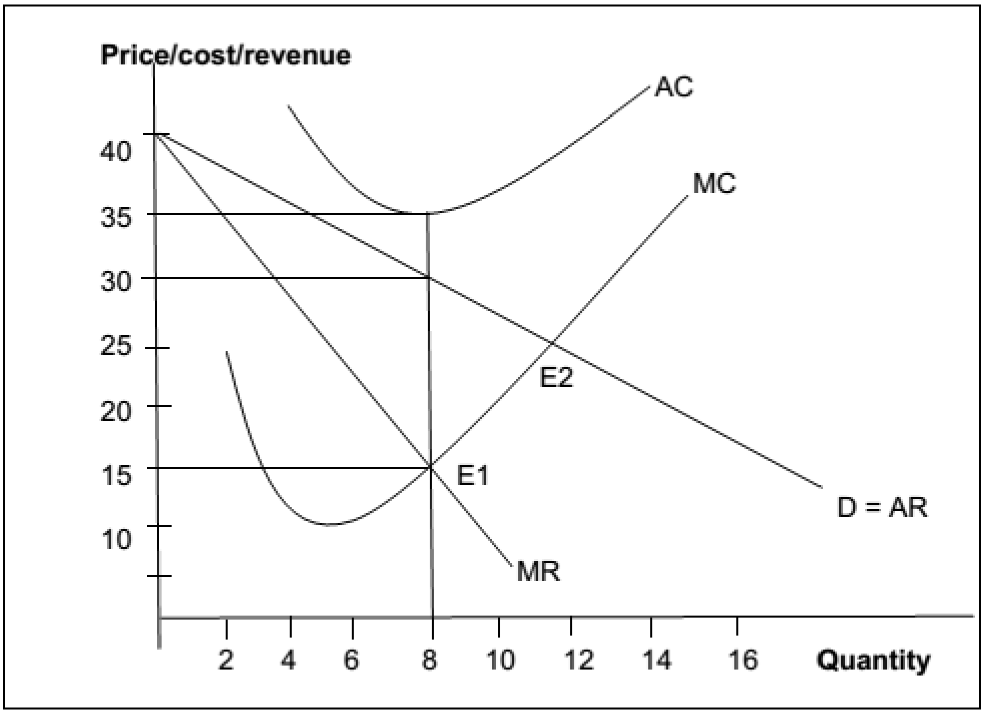
1.1 List TWO types of inefficiencies. (2 x 1) (2)

1.2 Briefly explain what a cartel is. (1 x 2) (2)

Question 2

(Adapted from EC Sept 2014, Paper 2, Question 2.2)

Study the graph below and answer questions that follow.



2.1 What type of market is represented by the graph above? (2)

2.2 Explain why the MR curve lies below the AR curve. (4)

2.3 Calculate the profit/loss of the above producer, and show all your calculations. (4)

Question 3

(Adapted from EC Sept 2014, Paper 2, Question 2.5)

With the aid of a graph explain the shutdown point of a firm under perfect competition. (8)

Question 4

(Adapted from EC Sept 2014, Paper 2, Question 4.1)

Answer the following questions.

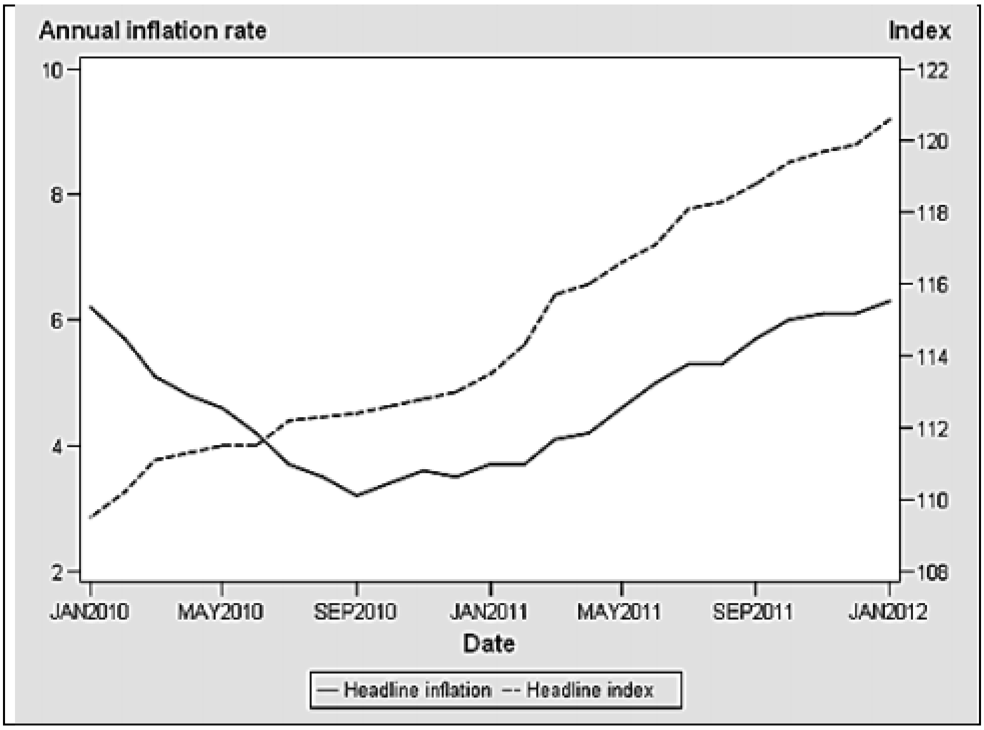
4.1 List any TWO aims of a competition policy. (2 x 1) (2)

4.2 Explain non-rivalry as a feature of public goods. (1 x 2) (2)

Question 5

(Adapted from EC Sept 2014, Paper 2, Question 4.2)

Study the graph below and answer the questions that follow



5.1 Define the concept headline inflation. (2)

5.2 In which month and year was South Africa's inflation rate at its lowest? (2)

5.3 Briefly explain South Africa's inflation targeting policy. (6)

Question 6

(Adapted from EC Sept 2014, Paper 2, Question 4.3)

Study the extract below and answer the questions that follow.

DISTINGUISHING YOUR BUSINESS FROM COMPETITION

When envisioning and establishing her business, Zilungile focused on both short term and long term goals. Her short term goal was to outgrow local competitors and gross sales. She knew she wanted to eventually compete with million other giants, but first she needed to examine her strengths and weaknesses.

Market competition can create a battleground and her goal was to win the war. This mindset might be controversial, but many businesses have failed because they did not capitalise on their competitors' faults. Zilungile distinguished her business by: analysing the industry, outshining the competition, focused on customer service, advertising, being proactive, to mention but a few.

[Adapted from the Internet, 2013]

6.1 What type of market was Zilungile's business operating in? (2)

6.2 Which economic concept can you align to the ways Zilungile distinguished her business? (2)

6.3 What, in your opinion, is meant by the sentence in italics? (2)

6.4 Explain the short run of a business. (4)

Question 7

(Adapted from EC Sept 2014, Paper 2, Question 4.4)

Distinguish between stagflation and hyperinflation. (2 x 4) (8)

Question 8

(Adapted from EC Sept 2014, Paper 2, Question 5)

"An oligopoly is characterised by a high degree of interdependence between firms."

In the light of the above statement explain other characteristics of an oligopoly and briefly explain the implication of a kinked demand curve. (40)

Question 9

(Adapted from EC Sept 2014, Paper 2, Question 6)

"South Africa must continue to employ forward looking inflation targeting in order to deal with current inflation pressures."

Discuss clearly the causes of both demand pull and cost push inflation.

Explain how a high rate of inflation can be reduced by a change in the repo rate. (40)

Answers

Question 1

(Adapted from EC Sept 2014, Paper 2, Question 2.1)

1.1 Allocative inefficiency √

Productive/Technical inefficiency √ (2 x 1) (2)

1.2 A type of collusion that occurs openly and formally between oligopolies. (1 x 2) (2)

Question 2

(Adapted from EC Sept 2014, Paper 2, Question 2.2)

2.1 Imperfect markets √√

2.2 The demand curve for an imperfect market is a downward sloping demand, which implies that, if it wishes to increase its sales by an additional unit, it must decrease the price of the product. √

The lower price applies to all its customers. √

Its marginal revenue, that is, the amount by which total revenue increases if it sells an additional unit, will therefore be less than the price, √

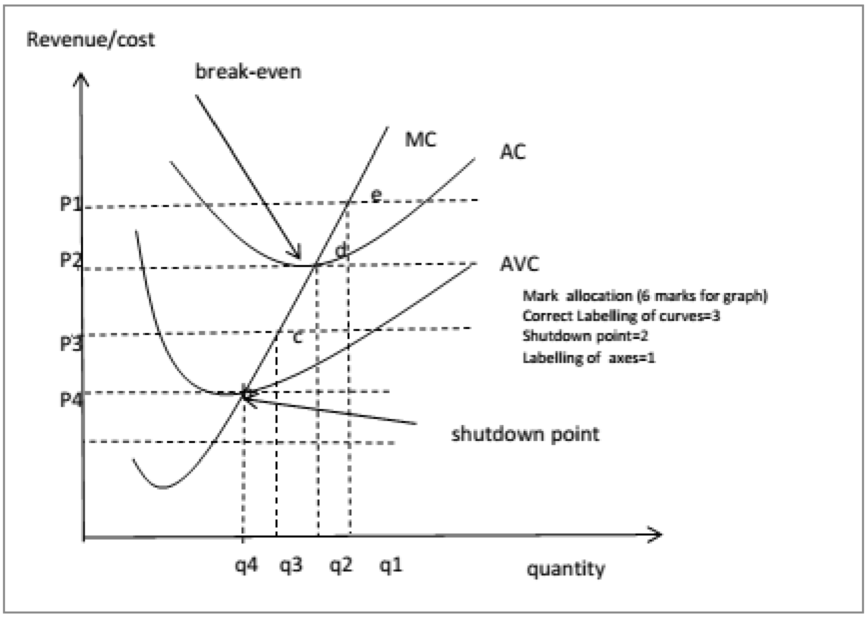
(NB. PRICE = AR). So, the marginal revenue curve will be below the average revenue. √

(4)

Question 3

(Adapted from EC Sept 2014, Paper 2, Question 2.5)

With the aid of a graph explain the shutdown point of a firm under perfect competition.



If the market price drops below P4, the business will not be able to continue and will be forced to close down, therefore point b is known as the close down or shut down point.

Question 4

(Adapted from EC Sept 2014, Paper 2, Question 4.1)

4.1 Improve the efficiency in markets through legislation.

Promote healthy competition between businesses.

Prevent unfair methods of achieving and exercising market power.

Prevent the abuse of market power by, for example, a monopoly.

Regulate the increase of market power by means of takeovers and mergers of large businesses.

Prevent restrictive practices, especially price-fixing and collusion by oligopolies

Protect the consumer against unfair prices and inferior products, for example through the Competition Act.

Contribute to South Africa's development objectives to ensure that all South Africans have equal opportunities to participate fairly in economic activities. (Any 2 x 1) (2)

4.2 Non-rivalry means that the consumption by one person does not in any way reduce the consumption by another individual, for example, a lighthouse and street lighting.

(1 x 2) (2)

Question 5

(Adapted from EC Sept 2014, Paper 2, Question 4.2)

DATA RESPONSE

5.1 Headline inflation: measures the total inflation within the economyincluding items that may cause sudden increases in the rate of inflation such as food and energy.Takes into account price changes in all goods and services in the basket as measured by the CPI.

(2)

5.2 September 2010 (2)

5.3 Inflation targeting is an economic (monetary) policy in which the central bank sets a preferred rate for inflation and then attempts to steer actual inflation toward that target.

In 2000, the SARB set an inflation target of between 3% and 6%.

It uses the CPIX rate, which excludes mortgage bond repayments that are determined by the interest rate. (Any 3 x 2) (6)

Question 6

(Adapted from EC Sept 2014, Paper 2, Question 4.3)

6.1 Monopolistic market (2)

6.2 Non-price competition (2)

6.3 Businesses competing fiercely for market share i.e. price wars, differentiated products, imaginary differentiation. (2)

6.4 Short run: A period whereby some factor inputs are fixed and output can only be adjusted by changing the quantities of variable factor inputs i.e. raw materials and labour. (4)

Question 7

(Adapted from EC Sept 2014, Paper 2, Question 4.4)

Stagflation:

Refers to a condition of stagnation of economic growth and high rates of inflation.

Occurs when a country experiences high inflation, a slowing economic growth rate and high unemployment.

When stagflation takes place it becomes difficult to design a policy that deals with it. (4)

Hyperinflation:

Occurs when there is an extremely high and rapid increase in price levels of more than 50% per month.

This is caused by a sustained increase in the printing of money by government to pay for its expenditures.

There is then 'far too much money chasing too few goods'.

When the price levels are rising so rapidly that people lose confidence in the value of money, it can be difficult for the economy to operate.

People resort to goods as a medium of exchange to make payment.

Barter makes a comeback with people exchanging goods for goods. (4)

Question 8

(Adapted from EC Sept 2014, Paper 2, Question 5)

INTRODUCTION

An oligopoly is a market structure which has a primary feature of having a few businesses and is mutually interdependent with each firm deciding upon its own prices and strategies. √√
(Accept any relevant introduction) (2)

BODY

Characteristics of oligopolies:

Number of firms

Oligopoly is a market structure dominated by a small number of large firms.

If there are only two firms in the market, it is called a duopoly.

Nature of products

Firms sell identical or differentiated products

Barriers to entry

There are significant barriers to entry, because of high capital needed to start the business.

Control over price

Producers generally have considerable control over the price of their products, although not as much as in a monopoly.

Oligopolies are characterised by price rigidity because if one cuts its price, rival firms retaliate by cutting theirs as well. A price cut by one firm initiates a price war in the market. √√

Incomplete information

Firms do not always have perfect information about circumstances in the market.

Each firm tries to prevent other firms in the industry from getting knowledge of its production processes, its new products, and the results of any new research.

Collusion

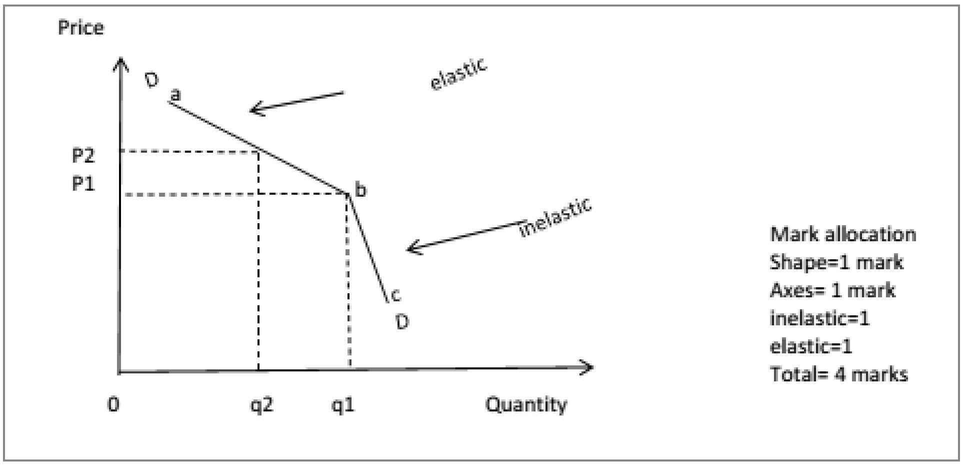
Collusion can take the two forms i.e. overt collusion and tacit collusion.

Tacit collusion or implicit collusion occurs when two or more firms in the same industry informally agree to control the market.

Overt collusion or explicit collusion occurs when two or more firms in the same industry formally agree to control the market. (Any 13 x 2) (26)

IMPLICATION OF THE KINKED DEMAND CURVE

KINKED DEMAND CURVE



- The behaviour of oligopolists cannot be predicted, because virtually anything can happen
- If the equilibrium price is P1 and the firm increases its price, while other firms do not follow, the firm faces a more elastic demand curve (between points a and b).
- This means that it will lose many sales for any increase in price.
- If the firm decreases its price, while other firms do not follow, it will face a more inelastic demand curve (between points b and c), that will allow its sales to increase.
- The kinked demand curve explains why prices in an oligopoly are rigid. (6)

CONCLUSION

An oligopoly is a tricky market structure, because of its nature of being unpredictable, and a disadvantage to consumers, because from time to time they tend to collude and prices may be quite high. (2)

Question 9

(Adapted from EC Sept 2014, Paper 2, Question 6)

INTRODUCTION

Inflation can be defined as a continuous and significant increase in prices over a period of time; there should be an increase in most goods and services for inflation to have taken place. (2)

BODY

Demand pull Inflation:

Demand pull inflation occurs when the total spending in the economy increases and the economy is unable to expand output to meet increase in spending, therefore prices tend to increase. √√

The following factors might cause demand pull inflation:

- Increased spending by households, may be caused by easy access to credit, and lower interest rates making credit cheaper.

- Increased investment spending by firms, increased business confidence caused by higher demand for goods and services.
- Increased spending by government, can be due to policies designed by government to deal with the issue of unemployment, providing more services to the public.
- Increased spending by foreign sector, can be due to higher demand for exports, or a decrease in the price of minerals, which increases the quantity demanded.
- Reduction in taxes, leaving more money in the pockets of consumers.

(Max. 14)

Cost push inflation

Cost push inflation has to do with an increase in costs of production.

In order to stay in the business, producers are compelled to pass these higher production costs on to consumers in the form of higher prices.

These are the factors that lead to cost push inflation:

- Increases in wages and salaries: If increases in wages and salaries are not accompanied by an increase production then the cost of production increases and prices in the economy increase.
- A decline in productivity: This means that it costs more to produce the same amount of goods and services, that results to an increase in price of goods and services.
- Increase in the price of imported goods/key inputs, i.e. intermediate goods and capital goods, this therefore results to an increase in costs of production.
- Increase in profit margins by firms: This causes an increase in costs of production, because profits are part of costs of production.
- Exchange rate depreciation leads to expensive imports.
- Natural disasters such as droughts, floods and even global warming, this has a great on costs of production for farmers. (Max. 12) (26)

HOW A HIGH RATE OF INFLATION CAN BE REDUCED BY A CHANGE IN THE REPO RATE

The South African Reserve Bank increases the repo rate to banks to reduce the availability of credit from the banks and to increase interest rate, which makes it more expensive to borrow money but, at the same time encourages savings.

Both of these would lead to a decrease in consumer demand, and therefore reduction in inflation.
(Any 5 x 2) (10)

CONCLUSION

If the inflation rate is not monitored carefully, and the above causes turn into reality, it could have a detrimental effect to the economy. (Accept any relevant conclusion.) (2)