



STRATHMORE INSTITUTE OF MATHEMATICAL SCIENCES

BBS Financial Economics/ BBS Finance

END OF SEMESTER EXAMINATION

BSE 1103: MICROECONOMICS I

DATE: 12th July 2017

TIME: 2 Hours

INSTRUCTIONS

- 1) Answer question one and any other two questions**
- 2) Question one is compulsory and carries 30 marks**
- 3) All other questions carry 20 marks each**

Question One (Total 30 marks)

- a) The government has increased regulations in the Home care businesses, for example by imposing minimum education requirements for home workers. Assume that these requirements improve the quality of home care thus increasing the demand for home care. At the same time, these government regulations have increased the cost of home care businesses. Draw a diagram to illustrate and explain the effects of these changes in the home care business. (7 marks)
- b) Maize prices in Kenya have skyrocketed as a result of drought and delayed rainfalls. Assume that to deal with future shortages, the government provides new improved maize seeds and subsidies to farmers, that result to bumper maize harvest. Using the concept of elasticity, use a suitable diagram(s) to illustrate and explain how the intervention by the government can actually be bad news to the maize farmers. (8 marks)

- c) A student makes the following comments that; ‘I believe that a firm in a competitive market making supernormal profits should produce where the distance between price and marginal cost is the greatest in order to maximize profit.’ Use a diagram to explain whether or not you agree with the student’s argument. (7 marks)
- d) Draw a diagram showing the usual relationship between the marginal cost of labor and the average cost of labor and explain their shapes. (Assume that labor is the only variable input). (8 marks)

Question Two (Total 20 marks)

- a) Suppose that increases in the price of strawberries leads to increases in the retail prices for ice cream by 4% from last year and ice cream consumption is down 3%. Given this information, calculate the price elasticity of demand for ice cream. Will the revenue received by ice cream suppliers have increased or decreased following the price increase? Briefly explain. (6 marks)
- b) One of the Kenya’s tourist hotels lost money for about a decade before finally closing down. Why would such a hotel continue losing money/ making losses for 10 years, rather than shut down immediately? While revenues cover a large part, but not all, of a firm’s cost, does it matter if the costs that are being referred to are fixed costs or variable costs? Briefly explain; Use an appropriate diagram. (6 marks)
- c) If market economies are more economically efficient than centrally planned economies, briefly discuss whether there would be a reason to prefer having a centrally planned economy rather than a market economy. (8 marks)

Question Three (Total 20 marks)

- a) Suppose that due to harsh climatic conditions, the supply of milk reduced and therefore increased the market price. The government imposes a price ceiling in order to make the milk affordable. Assume that there is no black market in the milk market. Use a graph to show these changes in the market and the areas representing consumer surplus, producer surplus and deadweight loss. (6 marks)
- b) Use a diagram to illustrate and explain why prices tend to remain sticky in an oligopoly market. (7 marks)
- c) The total cost function for a firm in a perfectly competitive market is given by the equation: $TC = Q^3 - 24Q^2 + 600Q$

where TC = total cost in Kshs and Q is quantity.

At what level of average cost will the firm maximise profit in the long-run? (7 marks)

Question Four (Total 20 marks)

- a) Sony will often sell electronic products at lower prices in the USA than in Japan. Does Sony consider the demand of US consumers for these products to be more elastic or less elastic than the demand of Japanese consumers? Briefly explain. (4 marks)
- b) Distinguish between transfer earnings and economic rent. (4 marks)
- c) Use a diagram to illustrate a case where all the earnings earned by a factor of production amount to economic rent. (6 marks)
- d) Clearly outline four factors that enable a firm to discriminate prices. (6 marks)

Question Five (Total 20 marks)

- a) Briefly explain four factors that may hinder firms from successfully forming cartels in order to increase their monopoly power in the market. (6 marks)
- b) Discuss four factors that influence the wage elasticity of labor. (8 marks)
- c) Discuss three diseconomies of scale that may accrue to a firm as it expands. (6 marks)