

ECON191

FINAL EXAM REVISION WORKSHOP **Semester One, 2013**

- **Drawing monopoly curve and understanding its components**
- **Looking at long-run monopolistic competition and inefficiency**
- **Oligopoly in practice – game theory and the pay-off matrix**
- **Asymmetry of information + eliminating moral hazard**
- **Correcting negative externalities of production**
- **Three theories to explain the slope of the AD curve**
- **Monetary and fiscal policy, and their effect on AD / Inflation**
- **Cost-push and demand-pull inflation**

BEFORE WE BEGIN...

Clark

- BA/BCom/CertLang
- ... and ECON 191 student!

Advised to look at Tutorials 5-11, especially 11!

Exam 100% or Test 30% and Exam 70%

MONOPOLY

Characteristics

Shape of the MC curve

Drawing monopoly graph

PRICE DISCRIMINATION

Conditions for price discrimination

What is price discrimination?

Why is it good / bad?

MONOPOLISTIC COMPETITION

Characteristics of monopolistic competition

Long-run situation for monopolistic competitor

- Demand curve becomes more elastic
- Lowest point AC cuts MC and tangent to AR=D

Inefficiency of the monopolistic competitor

PRODUCTIVE EFFICIENCY

$P = \min AC$

ALLOCATIVE EFFICIENCY

$MB \text{ or } D \text{ or } P = MC$

OLIGOPOLY + GAME THEORY

Game Theory – study of how people behave in strategic situations

Example pay-off matrix

The idea of a dominant strategy

ASYMMETRY OF INFORMATION

- **Asymmetric information** – different levels of information between buyer and seller
- **Adverse selection** – arises from asymmetric information, so buyer runs the risk of being sold a good of low quality
- **Moral hazard** – change of behaviour after a deal has been made / increased tendency to take risk
- **Principal-Agent Theory** - arises because of moral hazard... (more on the next slide)

MORAL HAZARD + PRINCIPAL-AGENT THEORY

Principal and Agent both pursue self-interest
– how do we get Agent to act in Principal's
best interests?

ANSWER: Efficiency Wages!

Above the market-clearing rate

WHY? Worker health, productivity etc.

EXTERNALITIES

Externality is a **spill-over effect / unintended effect on a third party.**

PRODUCTION vs CONSUMPTION

Common negative externalities of production are **pollution** and **second-hand smoke.**

NEGATIVE

Supply → Marginal Private Cost (MPC)

Demand → Marginal Benefit (MB)

(define Marginal utility, differentiate private vs. social)

MPC + External Costs = Marginal Social Cost (MSC)

Why is MSC higher than MPC? Externality is **negative**

GOVERNMENT SOLUTION?

- Corrective taxes, of course! (Pigouvian taxes)
- Consumer and producer surplus gets smaller...
bad or good?
- Deadweight... gain?

Tax should be as close to MSC as possible –
hopefully, MSC becomes MPC w/ tax

Market solution? Property rights

WHY DOES AD CURVE SLOPE DOWN LEFT TO RIGHT?

Wealth Effect

Price level falls \rightarrow increased real wealth \rightarrow increased C

Interest Rate Effect

Price level falls \rightarrow interest rate falls \rightarrow increased I

Exchange Rate Effect

Price level falls \rightarrow real exchange rate depreciates \rightarrow increased NX

Y/AD EQUATION

$$AD = C + I + G + NX$$

- **C**onsumption Spending
- **I**nvestment Spending
- **G**overnment Spending
- **N**et exports (exports – imports)

USING Y/AD EQUATION IN MONETARY + FISCAL POLICY

Monetary Policy

$$AD = C + I + G + NX$$

Fiscal Policy

$$AD = C + I + G + NX$$

FISCAL POLICY

When the government changes
TAXATION and/or GOVERNMENT SPENDING

Taxes fall → more money to spend → C rises
G falls because of less tax revenue

$$\underline{AD = C + I + G + NX}$$

AD changes depending on whether C rises more than G falls (and vice versa)

MONETARY POLICY

When Reserve Bank changes the Official Cash Rate (OCR), interest rates change.

When OCR rises, interest rates rise.

When OCR falls, interest rates fall.

OCR is currently 2.5% which is quite low, so interest rates are low.

MONETARY POLICY

Effect on CONSUMPTION SPENDING



MONETARY POLICY

Effect on INVESTMENT SPENDING



MONETARY POLICY

Effect on NET EXPORTS



- Foreigners lend us more money
- Demand for \$NZ rises
- \$NZ dollar appreciates
- Nominal exchange rises
- Foreign buyers must now buy relatively more of our dollar for a similar number of goods and services
- Exporters suffer, importers benefit
- **Net exports fall ($X < M$)**

MONETARY POLICY IN SUMMARY...

Interest rates rise
Incentive to save increases
Consumption Spending falls

Interest rates rise
Cost of borrowing increases
Investment Spending falls

IF THE RESERVE BANK
INCREASES
THE **OCR...**

Interest rates rise
Foreigners lend us money
Increased demand for \$NZ
Dollar appreciates → nominal exchange rate rises
Net exports fall ($X < M$)

SO...

If C, I and NX are falling, then **AD is assumed to fall (ceteris paribus)**
When AD falls, price level falls
LESS INFLATION!

INFLATION

Inflation is defined as a **sustained increase in the general price level**

Inflation removes the purchasing power of one unit of currency

TWO “TYPES” OF INFLATION:

cost-push and demand-pull

THE NATURE OF INFLATION

Inflation is not so bad!

If inflation is 200%, OK maybe yes we have grounds to lower the OCR into negative values, but inflation is not always a bad thing!

(Look at the *Does inflation impose costs on the economy?* part of your course book)

COST-PUSH INFLATION

Anything that shifts the AS curve left

Wages increase → increased costs of production

Cost of raw materials increases

etc.

This will mean firms are less willing / able to supply, so AS falls → AS shifts to the left.

DEMAND-PULL INFLATION

Anything that shifts the AD curve right

C, I, G and/or NX goes up = AD goes up

.... that's it really.

MACROECONOMICS IN SUMMARY...

- Three reasons behind the slope of the AD curve:
 - WEALTH EFFECT
 - INTEREST RATE EFFECT
 - EXCHANGE RATE EFFECT
- $Y/AD = C + I + G + NX$
- Monetary Policy = change in the OCR
- OCR increases \rightarrow interest rates increase
- Fiscal Policy = taxes / government spending
- Both monetary policy and fiscal policy have an effect on Aggregate Demand (AD)
- Reserve Bank use OCR as a market mechanism to keep inflation in check (Policy Targets Agreement)
- Demand-pull inflation = AGGREGATE DEMAND RISES
- Cost-push inflation = AGGREGATE SUPPLY FALLS

EXAM INFO

- Make your graphs **BIG!** (well, not TOO big)
- Calculator? Probably only for pay-off matrix
- There are NINE questions, with some “sub-questions” (e.g. 1a, 1b etc.)

**ALL THE BEST FOR
THE EXAM!**

**CHECK THE UNIVERSITY WEBSITE THIS
EVENING FOR EXAM ROOM ALLOCATIONS**