

UNIVERSITY OF COLOMBO  
FACULTY OF ARTS  
SECOND YEAR EXAMINATION IN ARTS (ECONOMICS) -2016/ 2017  
END OF THE SECOND SEMESTER  
**ECN 2224 – Economic Analysis**

Time: 2 Hours  
Answer 2 questions from Part A and 2 questions from Part B

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**Part A**

1. (a) Briefly list the difference between Adaptive Expectations and Rational Expectations, under the following criteria:
- (i) Variables considered in formulating expectations
  - (ii) Type of errors that can occur in expectations formation
- (3 Marks per section)
- (b)
- (i) Signal extraction problem
  - (ii) Information asymmetry problem
- In the context of a money supply expansion, explain the problem that occurs in each case.
- (4 Marks each)
- (c) Explain, using a diagram, the short run and long run impacts of a money supply expansion under information asymmetry.
- (5 Marks)
- (d) Explain why New Classical Economists argue that 'policy is ineffective' in the context of both rule-based and unanticipated monetary policy.
- (6 Marks)
2. New Keynesians provided a microeconomic rationale for unemployment, through focusing on labour and goods market imperfections.
- (a) Discuss briefly three labour market models/conditions that justify the existence of set wages that result in unemployment.
- (9 Marks)
- (b) Briefly give two explanations for the existence of set prices rather than constant market fluctuation in prices, put forward by the New Keynesians.
- (6 Marks)
- (c) Using a diagram briefly explain how set wages results in unemployment in the macro economy.
- (3 Marks)
- (d) Consider a shock to aggregate demand that reduces output, in a situation where

- labour contracts exist.
- (i) Draw a diagram to illustrate the above situation. What policy option do the New Keynesians have in this context? (4 Marks)
  - (ii) What would be the economic outcome that follows the above shock in aggregate demand, if no policy intervention was adopted? (3 Marks)
3. (a) There are four stages of the business cycle: Depression, Recovery, Prosperity and Recession. Discuss briefly what happens with regard to
- (i) Employment
  - (ii) Cost of production
  - (iii) Speculation
- in the recovery and prosperity periods. (3 Marks per section)
- (b) What creates the upper bound and the lower bound in the Hicks model of business cycles? (5 Marks)
- (c) Briefly explain two arguments put forward by New Classical Economists to explain the occurrence of business cycles. (6 Marks)
- (d) Briefly explain the different strategies for controlling business cycles proposed by
- (a) Keynesians
  - (b) New Keynesians
- (2.5 Marks per section)

### **Part B**

4. (a) Explain the concept of economic efficiency focusing on efficiency criteria and its measurements. (12.5 Marks)
- (b) How do you show that perfectly competitive markets are superior to imperfect markets in terms of economic efficiency? (12.5 Marks)
5. (a) What is meant by market failure? Explain the factors which can lead markets to fail. (12.5 Marks)
- (b) What measures can a government use to address market failures? (12.5 Marks)

6. (a) Solve the following game theory problems using the method given. Note down the steps you followed in reaching the solutions clearly.

(i) Iterated dominant strategy

		Player 2		
		Left	Centre	Right
Player 1	Top	73, 50	54, 72	66, 32
	Middle	80, 26	35, 42	64, 54
	Bottom	28, 27	63, 31	54, 29

(4 Marks)

(ii) Nash equilibrium

		Player 2		
		Left	Centre	Right
Player 1	Top	1,3	1,0	1,2
	Middle	2,1	4,3	2,2
	Bottom	1,4	3,2	-1,-1

(4 Marks)

(b) Give a numerical example of Multiple Nash equilibrium.

(3 Marks)

(c) Consider the following information.

$$Q = q_1 + q_2 \quad P(Q) = a - Q \quad \text{No fixed cost.} \quad \text{Marginal cost is constant at } c.$$

- (i) Prove that the Cournot model of duopoly leads to a higher market output than monopoly
- (ii) Prove that the Cournot model of duopoly leads to a lower profit for the firms than under monopoly.

(5 Marks each)

(d) What is the conceptual difference between the models put forward by Cournot and Stackelberg?

(4 Marks)

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