

UNIVERSITY OF COLOMBO
FACULTY OF ARTS
SECOND YEAR EXAMINATION IN ARTS (ECONOMICS) - 2017/2018
END OF THE SECOND SEMESTER
ECN 2218 – Microeconomic Analysis

Time: **Two (02) Hours**

Answer any four (04) questions

- 1.) "According to the First Theorem of Welfare Economics, all the Walrasian equilibria are Pareto efficient."
 - a.) State the key assumptions essential to derive the above theoretical deduction. (05 Marks)
 - b.) Briefly explain the relevance of the First Theorem of Welfare Economics to assess economic policies of a developing country. (08 Marks)
 - c.) Suppose all Sri Lankans living abroad decided to invest their income in Sri Lankan bonds market. What could be the general equilibrium impacts of this decision on the economy of Sri Lanka, in the short and long run? Briefly explain your answer. (12 Marks)

- 2.)
 - a.) Explain the difference between the Partial and General Equilibrium Analysis. (05 Marks)
 - b.) Differentiate between General Equilibrium and Macroeconomic equilibrium analysis. (08 Marks)
 - c.) General equilibrium is a more comprehensive analytical framework than Partial equilibrium analysis for policy evaluation. Explain this statement using a hypothetical example. (12 Marks)

- 3.)
 - a.) Compare and contrast the Pareto criterion and the Kaldor-Hicks criterion of resource allocation. (05 Marks)
 - b.) The free market system guarantees neither efficiency nor equity goals in an economy. Critically evaluate. (08 Marks)

- c) Suppose the Ministry of Education of a hypothetical country has decided to abolish the existing free education policy and to issue "education vouchers" for those who cannot afford the cost of education. Explain how these education vouchers would address the efficiency-equity tradeoff problem. Also explain the practical difficulties that would be faced in implementing an education voucher system.

(12 Marks)

4.)

- a) Compare the differences and similarities between "Economic Rationality (ER)" and "Common Knowledge of Rationality (CKR)".

(05 Marks)

- b) One of the key deductions of the "Prisoners' Dilemma" game is that cooperation is Pareto efficient but it is not the winning strategy. With an appropriate example describe under what conditions cooperation becomes the Nash Equilibrium in the Prisoners' Dilemma game.

(08 Marks)

- c) Suppose two parties (A and B) are in a dispute on dividing a one million rupees worth asset. First, Party A proposes a division such that proportion a goes to A and the balance $(1-a)$ goes to B.

Party B can accept or reject it. If B accepts, the dispute is over and the asset is divided based on A's proposal [a for A and $(1-a)$ for B].

If B disagrees, he proposes b and $(1-b)$ where b is the proportion that goes to A and $(1-b)$ goes to B. If A agrees the asset is divided according to the B's proposal.

However, if A does not agree, the problem has to be taken to a third party (an arbitrator) to settle. The arbitrator will charge 10 % of the value and propose an equal distribution of the balance [each gets 0.45 million rupees]. Find the Backwards Induction Nash Equilibrium of this bargaining game, and discuss important characteristics of the equilibrium.

(12 Marks)

5.)

- a.) Describe the key features of the "Battle of the Sexes" game.

(05 Marks)

- b.) In a single-period "Battle of the Sexes" game two (02) Nash Equilibria exist. However, if the same game is repeated, both players can use strategies to convince the other player to choose one strategy as the equilibrium action. Explain how a single-equilibrium would be reached in the "Battle of the Sexes" game in a repeated environment.

(08 Marks)

- c.) Use the Chicken-race game structure to explain political crisis situations in a hypothetical country.

(12 Marks)

6.)

a.) What is the “information problem” and how does it affect the properties of General Equilibrium?

(05 Marks)

b.) Explain two (02) economically optimal strategies to achieve Pareto efficiency under the asymmetric information problem in a free market system.

(08 Marks)

c.) How can regulations be used to minimize the “moral hazard” problem in the consumer durables market?

(12 Marks)

7.)

a.) What are the main components of “transaction cost”?

(05 Marks)

b.) Explain why “a proper legal framework” is required for the efficient functioning of the capitalist system.

(08 Marks)

c.) Some economists believe that regulations do not solve economic problems, they only change the shape of the problems. Critically evaluate this statement.

(12 Marks)

8.) Write brief explanatory notes on **any five (05)** topics given below.

a.) Insurance as a risk minimizing strategy.

b.) Investment in multiple qualifications by undergraduates in Arts faculties.

c.) Compensation Variation and Equivalent Variation

d.) Non-credible threats.

e.) Equilibrium vs. Disequilibrium Analysis.

f.) Rent-seeking behavior

g.) Pigouvian Tax

h.) Stag hunt game.

(05 Marks for each)

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