

Possible Test Questions for Economics Exam 2

1. The discount rate used in calculating the net present value of cash flows reflects the opportunity cost of capital. What does this statement mean?
2. Explain the nature of the relationship between net present value and the discount rate. Between net present value and the length of time that cash flows are expected.
3. Discuss the major limitation(s) of using the payback method to evaluate investment projects.
4. Management is evaluating a potential investment of \$100 million in a new plant. The alternative financing arrangements include the issue of bonds, equities or a mixture of the two. In each of the three (3) cases, how should the “appropriate” cost of capital be determined?
5. Explain the difference between the net present value and internal rate of return methods in evaluating potential investment projects.
6. What are the circumstances under which a perfectly competitive firm will produce zero output (“shut-down”) in the short-run? What determines whether a PC firm will continue to operate in the long-run? Use words and a graph to explain.
7. Explain the different types of barriers to entry that allow firms to have monopoly power. What is a “natural monopoly”? Give an example. What type of barrier to entry allows a natural monopoly to form?
8. Explain the idea of “price discrimination”. Be sure to differentiate between first, second and third degree price discrimination. What conditions must exist for a firm to be able to engage in this practice? What are firms trying to accomplish by engaging in price discrimination? Give examples of price discrimination that are encountered regularly.
9. In this class, we discussed the idea of “efficiency” in many different contexts. Recently, we made the assertion that conditions resulting from a perfectly competitive market were efficient. Why is this the case? How is this different from the conditions that result when a monopolist controls a given market?
10. Explain why a firm operating in an oligopoly industry where individual firms do not cooperate with each other might be reluctant to change the price of their product. Use both words and a graph to support your answer.
11. You are the owner of one of two beer manufacturers in a given market. Market demand for your products is such that you can successfully introduce new types of beer, provided that the new variation is introduced by only one firm and not the other. There is a market for a new “ice beer” and a new “red beer”, but each firm has the resources to introduce only one new product. If you both introduce the same type then you will each lose \$5 million. On the other hand, if you produce different types, then you will both increase profits by \$10 million. Construct the payoff matrix for the two firms regarding the decision of which of the two beers to produce. Is there a dominant strategy for either firm? Explain.

12. Compare and contrast the 4 basic market structures in terms of: efficiency, level of competition, conditions of entry, market power, and the profitability of individual firms. Also, give at least one example of a product sold in each type of industry.
13. Why would firms in an oligopoly want to collude? How would they do it? Why do most collusive agreements eventually fail?
14. Draw a graph for a monopolist showing the profit-maximizing price and quantity. Explain why these are the best price and quantity for the monopolist. Can the firm earn positive economic profits in the short run and the long run? Explain. (You may want to reproduce the illustration on your answer sheet).
15. What is the Herfindahl-Hishman Index (HHI) used for? How is it calculated?
16. Explain why a perfectly competitive firm is regarded as a “price taker”. What does the demand curve faced by this firm look like? Explain.
17. Give a brief description of the four generic pricing strategies. What is the basic strategy behind each?