KENYATTA UNIVERSITY

UNIVERSITY EXAMINATIONS 2016/2017

FIRST SEMESTER EXAMINATION FOR THE DEGREE OF BACHELOR OF ECONOMICS

EAE 408: ECONOMICS OF INDUSTRY

DATE: Wednesday, 30th November 2016 **TIME:** 4.30 p.m. - 6.30 p.m.

INSTRUCTIONS:

Answer QUESTION ONE (Compulsory) and any other TWO questions. Question one carries 30 marks and the ret carry 20 marks each.

Question One

a) Distinguish between Agency Costs and Transactions Costs **(2 marks)**

b) Explain why it is important for a firm to define its market **(4 marks)**

c) Hannah and Kay (1967) offer general conditions or requirements which should be satisfied by indexes if proper conclusions are to be arrived at. Clearly explain these requirements giving examples **(10 marks)**

d) Kenyatta University has contracted Hakim Construction Limited to supply construction materials for the Kenyatta University Teaching and Referral Hospital currently under construction next to the School of Economics. Hakim Construction has been ferrying the construction materials using the same route used by students while going for their lectures at the school. The Lorries have been causing heavy dust pollution that has been affecting student's health. As a result students have been incurring extra medical expenses. Suppose that the pollution cost to students is estimated at Ksh 2,000 per each lorry load ferried. Further you are provided with the following cost per lorry load by Hakim construction

Number of Lorry Loads	**1**	**2**	**3**	**4**	**5**
Cost to Hakim (Kshs)	**4,000**	**5,000**	**7,000**	**10,000**	**15,000**

Required

i) Using the above information calculate the Social Cost **(2marks)**

ii) If the revenue to Hakim Construction from a lorry load is ksh 3000. What is the optimal number of lorry loads should they transport? **(4 Marks)**

iii) If Hakim Construction is forced to internalize the pollution damage, how many lorry loads will they transport? **(4 marks)**

iv) Suppose students offer to pay Hakim Construction Ksh 8,000 to stop transporting the materials and Ksh 500 for every lorry transported. **(4 marks)**

QUESTION TWO

a) Equity as a building Society, focused on offering access and affordability of financial services to Kenyans through its savings model. In 2004, it converted from a building society to a full pledged bank. Equity disrupted the banking sector, turning it upside down largely by concentrating on the bottom of the pyramid space where 78 per cent of Kenya's population remained unbanked. It has over time introduced many products such as MKesho, Group lending, Consumer lending, and recently in 2014, it introduced Equitel. Equitel combines both banking and telecom services including data and sms services in a single simcard. In 2015, total loans disbursed through Equitel were Kshs 8.5 Billion, representing 78 per cent of the total loans issued by the bank. Explain reasons for this behavior by Equity bank and give examples of other firms in Kenya that might have followed the same trend **(10 Marks)**

b) Firms in monopolistic market structures normally incur advertising costs to market their slightly differentiated products and to inculcate brand loyalty among their clients. Explain the reasons for this kind of behavior **(10 marks)**

QUESTION THREE

a) Concerned about the number of commercial banks in Kenya and lack of aggressive competition that allowed the high interest rates and spreads between the lending and deposit rates in addition to the weakness in capitalization of many of them; the Central Bank of Kenya ordered the freezing of licensing of new lenders until further notice. The freezing on licensing and the demand for capitalization left the banks with few alternatives for entering into the highly lucrative banking sector. Using your knowledge from Economics of Industry, discuss giving relevant examples, the possible alternatives by the banks to meet the central bank requirements and the advantages of such alternatives **(10 Marks)**

b) "The degree of market power can be measured by the extent to which the monopolist can hold the price above the marginal cost". Using total revenue, marginal revenue and the concept of elasticity, explain this statement **(10 marks)**

QUESTION FOUR

Suppose a contract pay a hospital manager Wp when hospital is profitable and Wu when hospital is unprofitable. Effort of the manager is unobservable but profitability is a signal used to incentivize the manager to put high effort. For a high effort manager the expected utility is greater or equal to 10 units. The manager by putting high efforts get paid Wp with probability 0.8 if hospital is profitable and is paid Wu with probability 0.2 if hospital is unprofitable. Further, if manager puts low effort the hospital profitability changes to 0.4 if hospital is profitable and 0.6 if hospital is unprofitable. The hospital owner is interested in a contract such that the manager puts high effort. The cost to hospital manager for high effort is 2 and for low effort is zero.

Required

How much should he pay the manager for high effort and for low effort. Show all you workings **(20 marks)**

QUESTION FIVE

a) Explain the different circumstances under which integration among firms occur giving examples from Kenya **(10 marks)**

b) Explain the following economic concepts; **(10 marks)**

   i) Concentration ratio

   ii) Berry's index

   iii) Lerner index

   iv) Market structure

   v) Market conduct