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Short Answer Questions– based on Economic Theory

Competitive Dynamics in the Banking Sector

owner

[Pick the date]

Competitive Dynamics in the Banking Sector

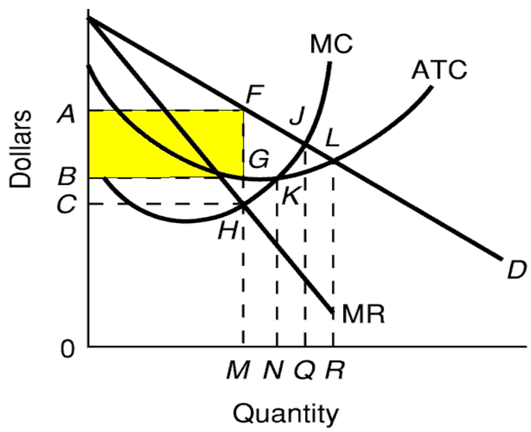
Part 1: Firm Perspective

1.

a. Australian banks operate in a financial market which is also an oligopoly. The term financial market is used to describe the markets where financial securities (such as stocks and bonds) and commodities are traded along the prices set by the demand and supply in the market. Oligopolies on the other hand are a kind of market structure where a few large firms dominate the industry or market, and in this case the financial market.

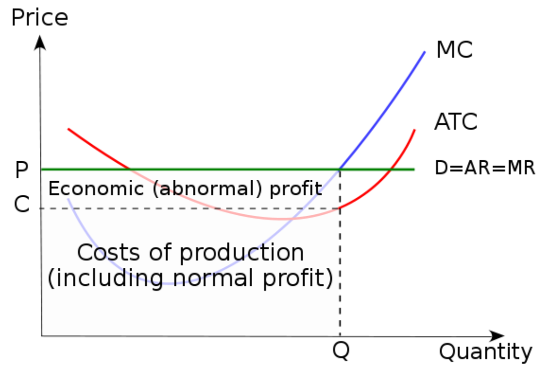
As a consequence of the Global Financial Crisis, banks in the Australian financial market merged together to limit competition in the open market and expand their share of the market. The large dominating firms were able to remain stable and they became the dominant price setters while the smaller banks became the followers or price takers. There were no barriers to entry before and entry could take place due to the capacity for economic profit. However now only near to normal profit is being made and so other banks do not enter the market. The government is also hard pressed to increase competition in the financial market before the large firms start acting like a monopoly (Dineshbakshi.com, 2014).

b. Collusion is when firms decide to act like a monopoly in the market or when a dominant firm sets the market price and other firms follow the leader. If the biggest four banks in Australia decided to collude and charge a higher price on banking products then this shows that they are trying to maximize industry profit rather than individual firm profit. The total output produced will be lesser than before even though the price will be higher. They will set monopoly price in the market and sell monopoly quantity therefore quantity M will be sold at price A as shown in the diagram below. The quantity of output M will be divided up amongst these banks based on ether equal share, firm size or maybe non price competition. The actual quantity that should be produced or was being produced was quantity Q at a price lower than A. (Economics Help, 2014)



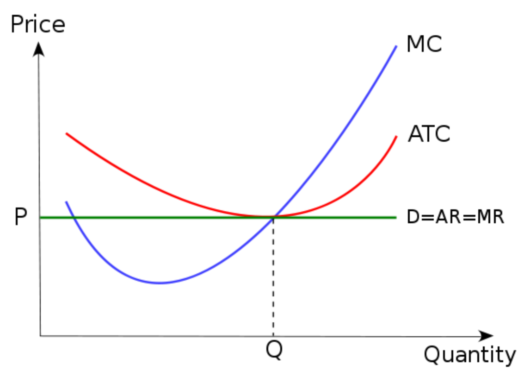
Source of diagram: **Bamford and Grant, 2010**

2. Perfect competition is characterized by a large number of buyers and sellers that have, perfect knowledge and homogenous products. The firms themselves are the price makers and there is freedom of entry and exit. What triggers entry into a perfectly competitive market is the fact that individual firms are able to make abnormal profit in the short run. The firm has a horizontal demand or average revenue curve and it can sell any amount of output at the same price as the price or average revenue is above the average cost as shown in the diagram below.



Source of diagram: **Bamford and Grant, 2010**

This leads to entry into the market by other firms in the long run to profit maximize, however as more and more firms enter the demand curve of each individual firm shifts downward bringing down with it the price, average revenue and marginal revenue curve. This is shown by the graph below.



Source of Diagram: **Bamford and Grant, 2010**

Now there is only normal profit in the short run and long run therefore no other firm chooses to enter into the market now. (Hassen, 2003) In short, abnormal profit in the short run causes entry in the long run and the entry of firms creates normal profit in the short run which limits entry in the long run.

Competitive Dynamics in the Banking Sector

Part 2: Macroeconomic Perspective

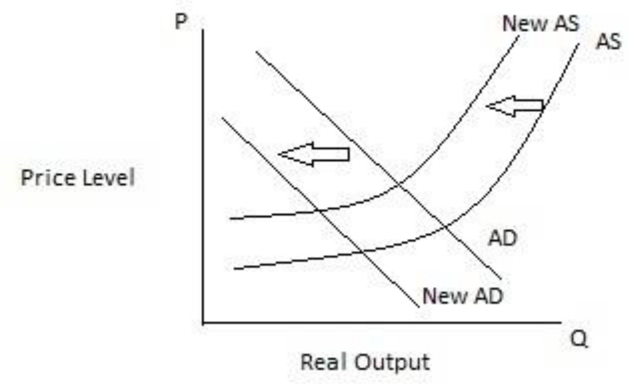
1.

a. The short run equilibrium for Japan's GDP will be at a price level of 95 and a real GDP of 500 trillion yen

b. Japan has a recessionary gap since the real GDP is lesser than the potential GDP and the magnitude of this recessionary gap is 100 trillion yen.

2.

a. According to the Greece Economic Forecast 2015, Greece's GDP is going to decrease when compared with the previous year. The GDP is a country's total production and is related to consumption which is one of the components of a country's aggregate demand. If GDP decreases then it means that aggregate demand for the country's goods and services has fallen (Harpercollege.edu, 2014). The other components of aggregate demand include government spending, investment and net exports. The information shows that government spending is also predicted to decrease by 19.9 in 2015 but on the other hand the net exports will be better off than before even though the balance of trade will still remain negative. It can also be seen that the number of employed people will increase a little but the working population is decreasing along with the youth employment rate which are contributing factors in shifting the aggregate supply curve to the left. All in all, the country's aggregate demand curve is predicted to shift to the left along with the aggregate supply curve.



b. The problems faced by Greece are low economic growth and activity along with a negative balance of trade and a high unemployment rate. The government can undertake the expansionary fiscal policy to address these problems. An expansionary fiscal policy consists of the government spending more than the tax revenue or cutting down taxes to influence the aggregate demand and economic activity in such a way that the aggregate demand in the economy rises. Government spending is a component of AD and so AD is increased but not only this, employment level is also raised since more job opportunities are available as economic activity is increased. Apart from this the expansionary fiscal policy also has an effect on net exports. (Investopedia, 2014) This happens because government borrowing raises the interest rates of the economy and this automatically attracts foreign investors because they need the economy’s currency to buy bonds from that country (Sparknotes.com, 2014). Hence the demand for that economy’s currency increases which raises the price of the good its exporting. When net exports increase or turn positive along with the government spending then it will shift Greece’s AD curve to the right and the country will start experiencing a boom. The AS curve will also shift right due to the employment level rising.

c. The basic challenge that the Greek government would face when using the fiscal policy is the crowding out effect. The crowding out effect refers to when a government increases it's spending and the interest rates rise but investment decreases. Crowding out always occurs when expansionary fiscal policy is used because investment is the most reactive or sensitive to changes in interest rates and if interest rates rise then investment decreases. (Oswego, 2000) Therefore an increased government spending has the tendency to crowd out private investment.

d. Unemployment rate in 2014: 1319620/11290000 * 100% = 11.69%

Unemployment rate in 2015: 1300000/11240000 * 100% = 11.56%

Labor force participation rate in 2014: 4928880/11290000 * 100% = 43.66%

Labor force participation rate in 2015: 5081000/11240000 * 100% = 45.2%

e. It can be forecasted that employment in Greece will rise by 2015 as compared to the current year 2014. Even though the working age population is decreasing, the labor force participation rate will rise from 43.6 to 45.2 percent as the unemployment rate simultaneously falls from 11.7 to 11.56 percent. This is not much of a difference but it is still a positive change. The youth employment rate is also decreasing which can perhaps be due to more of the youth continuing education rather than working early. This will further help in the long run.

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