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Economics 202

Midterm #1: Solutions

1. d
2. c
3. a
4. e
5. b
6. c
7. e
8. a
9. b
10. d
11. c
12. d
13. c
14. a
15. c
16. b
17. d
18. b
19. d
20. b
21. d
22. a
23. b
24. c
25. d
26. c
27. a
28. c
29. d
30. b
31. e
32. c
33. d
34. a
35. d

Part 2. Solutions to the Short Answer Questions

Questions #1-4 consider the PPC relationship in Country A for tractors and automobiles. You may use graphs as part of your explanation or just explain without a graph.

[4 pts] *1. How does an increase in the demand for tractors affect the PPC of Country A? (assume full employment throughout this change)*

There is no shift in the PPC, simply movement from point to point along the curve, toward tractors and away from automobiles.

[4 pts] *2. How does a decrease in the productivity of tractor company employees (only) affect the PPC of Country A?*

There is an inward shift in the curve, but only for one tractors. The shift (decrease) shows lower levels of tractor production for every unit of automobile produced, until you get to the point where you would be specializing in automobiles. We also refer to this as a pivot, where all points but the intercept point on the automobiles axis will shift inward.

[4 pts] *3. How does technological change within (only) the automobile industry affect the PPC of Country A?*

There is an outward shift in the PPC, but only for one good (automobiles). The shift (increase) shows higher levels of potential in automobile production for each unit of tractor produced, until you get to the point where only tractors are produced.

[4 pts] *4. How would relaxed migration policy, which leads to an increase in migration into Country A, affect the PPC of Country A?*

There is an outward shift in the curve for both automobiles and tractors. More factors implies a greater potential, but for both goods.

Part 2. Short Answer Questions cont.

In answering the question below, if a calculation is required, then you must show any relevant work or make it very clear as to how you arrived at your answer. Just providing an answer without supporting work or any explanation will not allow you to get any credit for your answer.

[8 pts] *5. The Tables below represent the Production Possibilities of two different countries, Country X and Country Y, who produce wheat and rye with constant opportunity cost.*

Country X	A_1	A_2	A_3	A_4
Quantity of Wheat	0	30	45	75
Quantity of Rye	100	60	40	0

Country Y	B_1	B_2	B_3	B_4
Quantity of Wheat	0	20	60	100
Quantity of Rye	50	40	20	0

Show which country has the comparative advantage in producing wheat, and which country has the comparative advantage in producing rye?

Note that there is work involved with answering this question, and you must show enough of your work to make it very clear as to how you got your answer.

Country X

- Opportunity cost of each unit of wheat = 4/3 units of rye
- Opportunity cost of each unit of rye = 3/4 units of wheat

Country Y

- Opportunity cost of each unit of wheat = 1/2 units of rye
- Opportunity cost of each unit of rye = 2 units of wheat

Based on the calculation of opportunity cost within each country, Country Y has a comparative advantage in producing wheat, and Country X has a comparative advantage in producing rye

Part 2. Short Answer Questions cont.

[6 pts] *6. Suppose you're the manager of some rural bank (the only bank in the area), and you know that inflation is coming. What would you do with the interest rates you charge on fixed rate loans? Explain.*

When it comes to loans, the bank is a creditor (i.e., a lender). Borrowers are always better off with inflation and creditors worse off, because inflation erodes the value or purchasing power of the money being repaid. As a creditor, the bank would typically have an incentive to raise interest rates, so that when borrowers pay back their loans, this money will have the same “real value” or purchasing power as before the inflation. However, when inflation changes unexpectedly, the bank does not realize that inflation has occurred, and they are unable to increase interest rates at the moment inflation first takes place.