NAME: _____ STUDENT NO:_____

Section No. ***Please circle*** (001=morning, 003 = aft)

THE UNIVERSITY OF WESTERN ONTARIO
LONDON CANADA

L. MacDonald **Economics 2152B-001/003** **March 2014**

MIDTERM 2- Version 222

INSTRUCTIONS:

1. The exam is two hours long.

2. The exam consists of 10 multiple choice questions worth 2 marks each, 10 True/False questions worth 2 marks and 4 short answer questions, worth a total of 38 marks. The marks for each question appear in brackets beside each question. The exam is worth 78 marks.

3. Record your name, student number and section number on the exam paper, Scantron sheet and the work booklet. **The code 222 should be pre-printed on your scantron sheet. Make sure it matches the code on your exam. Any attempt to change the code will be viewed as an attempt to cheat and you will receive zero on this exam.** Answers to the multiple choice and true/false should go on the Scantron sheet provided **IN PENCIL ONLY.** Answers to the short answers should go directly on the exam paper in the space provided. Show all other work in the work booklet provided (this is for your reference only – it will ***not*** be marked.)

4. Answers to the multiple choice should be recorded in your work booklet as these answer sheets will **not** be returned. The work booklet can be collected after the exam paper is returned to you.

5. Unless told otherwise, you may assume that leisure, current consumption and future consumption are normal goods and that taxes are lump-sum. Also, do not assume Ricardian Equivalence holds unless indicated otherwise.

6. If there is a discrepancy between the lecture notes and the textbook, the lecture notes will over-ride the textbook.

7. Please hand in **all** materials to the proctors. The exam paper will be returned to you after it has been marked. You can collect the work booklet after the exam has been marked.

8. Calculators are allowed, ***out of their cases***. Programmable calculators, graphing calculators and cell phone calculators are NOT allowed. English dictionaries are NOT allowed. Pencil cases are **not** allowed.

9. There will be no bathroom breaks allowed.

10. GOOD LUCK!

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PART I. Multiple Choice. Choose the best answer. Each question is worth 2 marks. Enter your answers directly on the Scantron sheet provided in *pencil* only.

Chapter 8 questions

1) For a **lender**, a decrease in the real interest rate _____ (increases/decreases/ambiguous/does not change) current consumption and _____ (increases/decreases/ambiguous/does not change) savings, and _____ (increases, decreases, ambiguous/does not change) future consumption if the income effect is **equal to** the substitution effect.

A) increases, decreases, decreases.
B) decreases, decreases, decreases.
C) does not change, ambiguous, increases.
D) ambiguous, ambiguous, decreases.
E) does not change, does not change, decreases.

2) A decrease in the interest rate leads to a

A) parallel shift of the budget line to the left.
B) rotates the budget line inwards on the horizontal axis and becomes steeper.
C) rotates the budget line inwards on the horizontal axis and becomes flatter.
D) rotates the budget line inwards on the vertical axis and becomes flatter.
E) rotates the budget line inwards on the vertical axis and becomes steeper.

3) If consumers expect a tax cut to be permanent

A) consumption remains unchanged.
B) the increase in consumption will be much larger than for a temporary tax cut
C) the decrease in consumption will be much smaller than for a temporary tax cut.
D) the increase in consumption will be much smaller than for a temporary tax cut.
E) Savings will be unchanged.

4) Assume that lending rates are lower than borrowing rates and the consumer is originally consuming at the endowment point. What will happen if the lending rate increases so that it is now equal to the borrowing rate?

A) current consumption will rise.
B) future consumption will rise.
C) savings will rise.
D) all of the above.
E) only B and C are true.

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5) If there is a decrease in current income of $1000, and an increase in future income of $1000, it will lead to

A) an increase in first-period consumption, a decrease in second-period consumption, and an increase in saving.
B) a decrease in first-period consumption, an increase in second-period consumption, and an increase in saving.
C) an increase in first-period consumption, an increase in second-period consumption, and an increase in saving.
D) a decrease in first-period consumption, a decrease in second-period consumption, and a decrease in saving.
E) no change in current consumption or future consumption but savings increases.

Chapter 5 questions

6) If the consumer is originally consuming where MRT > MRS, a move to a Pareto optimal equilibrium will lead to

A) Leisure falls and consumption rises.
B) Leisure rises and consumption increases.
C) Leisure rises and consumption falls.
D) Leisure falls and consumption falls.
E) Labour supplied falls and consumption rises.

7) Which of the following is true?

A) Pareto optimality implies that everyone is on his or her highest affordable indifference curve.
B) The competitive equilibrium will always be Pareto optimal.
C) The monopolist equilibrium can never be Pareto optimal.
D) if there is a tax in a perfectly competitive market, the equilibrium can never be Pareto optimal.
E) none of the above.

8) Which of the following results of our model are inconsistent with business cycle facts following an increase in government purchases?

A) employment is procyclical.
B) consumption is countercyclical.
C) wages are countercyclical.
D) GDP increases.
E) B and C.

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9) If there is a negative shock to total factor productivity this will cause the PPF to

A) shift up in a parallel manner.
B) shift down in a parallel manner.
C) shift up and become steeper.
D) shift down and become flatter.
E) shift down and become steeper.

10) If increases in government spending are invested in areas that increase the productivity of firms, which of the following is **true**? (Hint: think of the in class problems)

A) The effect on consumption will be ambiguous.
B) the effect on leisure will be ambiguous.
C) Output will rise.
D) All of the above are true.
E) Only B and C are true.

PART II. TRUE/FALSE. Enter A for a True answer and B for a False answer directly on the Scantron sheet.

Chapter 8 Questions.

11) Savings will increase less with a permanent increase in income versus a temporary increase in income.

12) If the government borrows in period 1, there must be more consumers who are savers/lenders than borrowers.

13) If everyone pays the same tax rates, and all taxes are lump-sum, then Ricardian equivalence MUST hold for a current tax cut.

14) If consumers are credit-constrained, and cannot borrow at all, a cut in taxes will lead to both an increase in consumption and an increase in savings.

15) If the government borrows in period 1, then taxes must exceed government spending in period 2.

Chapter 5 Questions.

16) A negative externality will lead to too much being produced of an item relative to the Pareto optimal equilibrium.

17) An income tax on wages will lead to too little labour being supplied.

18) Income and substitution effects must be equal in magnitude if changes in technology are to fit with empirical facts in the *short run.*

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19) Full crowding out will **always** occur when the government keeps its budget balanced.

20) If we introduced the concept of Ricardian equivalence into our model from Chapter 5, it would imply that the income effect of a decrease in taxes would be zero.

PART III. SHORT ANSWER QUESTIONS. ENTER YOUR ANSWERS DIRECTLY ON THE EXAM PAPER IN THE SPACE PROVIDED. Your work booklet will NOT be marked. It is for your reference only. Marks for each question appear in brackets beside the question. (38 marks). Please feel free to use symbols and letters.

1. Using the model from **chapter 8,** provide one example that invalidates Ricardian Equivalence. Explain using the definition of Ricardian equivalence, making sure you describe the impacts of your example on current consumption, future consumption and saving. (4 marks)

2. If there is a decrease in interest rates in the **Chapter 8 model,**

   A) Explain ***briefly*** the substitution effect on *C, C' and S* for a borrower. (4 marks)

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B) Explain ***briefly*** the income effect on *C, C' and S* for a lender. (4 marks)

C) Assume that savings falls for a lender, which effect must be larger? (1 mark)

D) Assume that savings falls for a borrower. Which effect must be larger? Explain briefly. (2 marks).

3. Using the model from **chapter 5,** state what happens to ***Y, N, w, C and ℓ*** when.....(you do not need to draw a graph)

   a) There is an increase in government spending. Explain briefly your answers. (8 marks)

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b) There is an earthquake which destroys 50% of the economy's factories. Explain briefly the **final** effect on the variables. You do not need to draw a graph. (9 marks)

4. Fill in the blanks with the **direction** of change plus the **variable**.
   Partial crowding out in the **chapter 5** model occurs when there is a/an _____ (increase/decrease) in _____, which leads to a/an _____(increase/decrease)in _____which leads to a/an _____ (increase/decrease/no change) in _____.

   (6 marks)

Make sure that your name and student number is on the front page of your exam and the Scantron sheet and make sure that all short answers go directly on the exam paper in the space provided. Happy St. Paddy's Day!

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