Key to Microeconomics Test 1

Short answer essay and/or graph (55 pts)

Answers in italics. The answers to these questions should contain the following elements explicitly or implicitly:

1. (15 pts) David Ricardo developed the theory of comparative advantage. Use this theory to answer the following
   a) What is absolute advantage and what is comparative advantage.
      Absolute advantage: refers to a producer having higher efficiency of production. Efficiency refers to ability to produce more output with same resources.
      Comparative advantage: between two(or more) producers, a comparative advantage indicates lower relative opportunity costs.
   b) Why would a country import an item from another country that was less efficient at producing that item?
      Trade is guided by comparative advantage, not absolute advantage or efficiency.
   c) Why is trade beneficial to both countries?
      Trade allows a country to move outside its own production possibilities curve. Depending on the relative prices of its imports and exports, it may become much better off than if it was self-sufficient.

2. (10 pts) As used in an Aplia problem, consider the tradeoff between fuel efficiency and automobile safety. Draw a graph and then show the effect of a new material that is as strong as steel but lighter. Draw a PPC with axes for Fuel Efficiency and Automobile Safety(preferably curved). Show end attached to fuel efficiency moving outward (reflecting lighter material) while other end stays constant.

3. (15 pts) Consider the market for pizza using S&D. Show the effect of each of the following on equilibrium price and quantity of each of the following: (explain what shifts and why). Draw two separate graphs.
   a. Opening new pizza parlors
      Must have fully labeled supply and demand graph showing beginning and ending equilibria. In this case, the Supply of pizza shifts to the right (increases) due to the new firms (increased market size) resulting in lower prices and increased quantity.
   b. A decrease in the price of hamburgers
      Assuming hamburgers are a substitute, as the price of a substitute decreases, the demand for pizza will also decrease. This results in a shift to the left (decrease) of Demand resulting in lower prices and quantity.

4. (5 pts) A student says "an increase in price causes a decrease in demand", I say that is wrong. Explain.
   An increase in price only causes a movement along the demand curve. The phrase decrease in demand means that the demand curve shifts. The demand curve NEVER shifts because of a price change.

5. (5 pts) What does it mean to say that market equilibrium is stable.
   When the market reaches equilibria, the natural price and market price are equal. At equilibrium, the quantity supplied equals the quantity demanded meaning the market clears. The market will remain at equilibrium unless some outside force causes it to move away. If the market is not in equilibrium, ie has a surplus or shortage, the invisible hand will guide it towards equilibrium.
6. (5 pts) Why is a Production possibilities curve curved instead of a straight line? Specialized resources imply different productivity and hence different opportunity costs. Assuming that a person hires or fires according to ability (rather than randomly), as more people are hired, the productivity decreases, resulting in increasing marginal opportunity costs. Since the slope of the PPC is opportunity cost.

Multiple Choice (40 points, answer on scantron)

1. Which of the following is not one of the assumptions about economic psychology:
   a. Rational
   b. Maximizes
   c. Amoral
   d. Self-interested

2. A student on the Millenium scholarship is trying to decide whether to take Economics or Sociology. If they were both covered by the scholarship and if they had the same book costs, the opportunity cost of taking economics would be:
   a. Zero
   b. Not taking sociology
   c. The same as sociology
   d. Tuition and books

3. As discussed in class, ticket scalping (selling tickets at higher than face value on the night of an event) is an example of
   a. Inefficiency
   b. The opportunity cost of standing in line
   c. Diminishing marginal utility
   d. A price ceiling

4. If a point was inside the production possibilities curve, that would represent:
   a. An impossible point
   b. An efficient point
   c. An inefficient point
   d. An increase in resources

5. The production possibilities curve is drawn as a curve because:
   a. There are increasing opportunity costs
   b. The production is efficient
   c. Resources are unspecialized
   d. Opportunity costs are constant

6. The slope of the production possibilities curve is:
   a. Marginal utility
   b. The same as the demand curve
   c. Marginal opportunity costs
   d. Always linear

7. If costs increase, a production possibilities curve will be shown as:
   a. An increase (shift right)
   b. No change
   c. A move along the production possibilities curve, not shift
   d. A decrease (shift left)

8. If technology improves, that will be reflected on the supply curve as:
a. An increase (shift right)
b. No change
c. A move along the supply curve, not a shift
d. A decrease (shift left)

9. Which of the following will NOT cause supply to change:
   a. An increase in costs
   b. An increase in the number of firms
   c. An increase in the price of another product
   d. An increase in demand

10. The demand curve will shift right (increase) if:
    a. Price increases
    b. Technology decreases
    c. Income increases
    d. Price of a substitute decreases

11. Ceteris paribus means:
    a. Everything changes
    b. Nothing changes
    c. Everything else remains constant
    d. Everything else changes

12. Using the class attendance example, why would more people be expected to attend class at least once per week compared to twice per week.
    a. Opportunity costs decrease
    b. Marginal benefit decreases
    c. Marginal costs decrease
    d. Because they have nothing better to do

13. When the market is in equilibrium,
    a. Natural price equals market price
    b. Quantity supplied exceeds quantity demanded
    c. Demand equals supply
    d. It will tend to move away from equilibrium

14. An effective (binding) price floor would cause:
    a. A price lower than equilibrium
    b. A surplus
    c. A shortage

15. Consider the market for gasoline, after hurricane Katrina knocked out oil producing/refining, we would expect:
    a. Demand will decrease
    b. Supply will decrease
    c. A decrease in quantity and a decrease in price
    d. An increase in price and an increase in quantity

16. If the major economic effect of hurricane Katrina was causing people to lose jobs; in the market for gasoline, this would cause:
    a. An increase in demand
    b. A decrease in demand due to higher prices
    c. A decrease in demand due to lower income
d. An increase in prices and quantity

17. The normal reason given for a price floor is:
   a. To help low income consumers
   b. To help low cost producers
   c. To help imports
   d. To help high cost producers

18. Consider the market for music file downloads and consider the effect of increased RIAA lawsuits against illegal downloaders. This would cause:
   a. An increase in illegal downloading
   b. An increase in demand for legal downloads
   c. A decrease in demand for legal downloads
   d. A decrease in the price of legal downloads

19. A person is trying to decide whether to buy an additional bottle of Wine. This is an example of:
   a. Opportunity cost
   b. A marginal decision
   c. Irrational decision-making
   d. Insatiability

20. Adam Smith’s theory of the invisible hand can be used to explain:
   a. Why government is not needed to control the market
   b. Why the market tends to move away from equilibrium
   c. Why a shortage results from too high a price
   d. Why natural price is always higher than the market price