

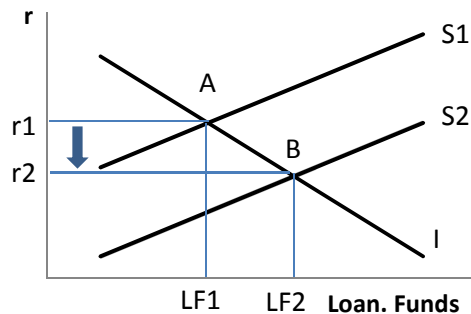
ECO1102C, University of Ottawa
Midterm: October 9, 2014
Answer Key

Multiple Choice (80 points; 2 points each)

1. B	11. C	21. B	31. B
2. C	12. D	22. C	32. C
3. D	13. A	23. D	33. C
4. D	14. A	24. C	34. D
5. D	15. C	25. A	35. B
6. C	16. B	26. D	36. C
7. D	17. C	27. D	37. B
8. D	18. C	28. B	38. C
9. B	19. B	29. B	39. C
10. B	20. C	30. B	40. B

Short Answer (20 points)

41. (3 points for graph)



(4 points for explanation) As shown in the graph above, the initial equilibrium in the market for loanable funds, at point A, is characterized by an equilibrium interest rate of r_1 and an equilibrium quantity of saving and investment of LF_1 . If the government goes from a deficit to a surplus, then there will be more public saving in the economy at each interest rate, and the amount of national saving in the economy will increase. This will shift the supply curve for saving from S_1 to S_2 . As a result, a new equilibrium will be at point B. This equilibrium will be characterized by a lower interest rate, r_2 , and a higher level of saving and investment, LF_2 . Hence, the budget surplus will cause interest rates to fall and investment to increase.

42. The argument that poor countries will tend to catch up with rich ones is based on the idea that an additional unit of capital will increase productivity and output more in a country that has a small amount of capital to begin with, than in one that already has a lot of capital. Hence, if the savings rate (or the share of GDP devoted to investment) is the same in a rich and a poor country, the poor country will grow faster than the rich one. In other words, the output of the poorer country will “catch up” to the output of the richer country. (3 points)

However, this argument assumes that “other things are the same” – that all other determinants of productivity and output, other than capital, are held constant. Some things that would tend to prohibit or limit a poor country’s ability to catch up with rich ones include the following. (4 points; 1 for each determinant and explanation given; there are more examples below than are required to obtain the full 4 points)

- If the share of GDP invested in the poor country is lower. The capital stock would not increase as much.
- If the level of education is lower in the poorer country. To get the most out of physical capital, there must be investment in human capital.
- If population growth is higher in the poorer country. Countries with fast population growth tend to have lower educational attainment.
- If the level of health care is lower in the poorer country. Healthier workers are more productive.
- If property rights are not respected or there is political instability in the poorer country. Growth requires a stable and honest government, law enforcement and effective courts.
- If there are legal or geographic restrictions on trade in the poorer country. There would be less productivity and lower living standards since the country cannot focus on producing what it produces best.
- If there are restrictions on the foreign ownership of domestic capital in the poorer country. There would be less foreign investment and technology transfer.
- If support for technological process is lower in the poorer country. Technological progress is the main reason why living standards rise over the long run.

43. a) (1 point) The price of 1926 movie ticket is worth $0.25 \times \frac{177}{17.7} = \2.50 in today’s dollars.

b) (3 points) The three major problems in using the CPI as a measure of the cost of living are:

- Substitution bias: The CPI ignores the fact that consumers substitute toward goods that have become relatively less expensive.
- Introduction of new goods: Because the CPI uses a fixed basket of goods, it does not take into account the increased well-being of consumers created when new goods are introduced.
- Unmeasured quality change. Not all quality changes can be measured or measured accurately.

c) (2 points) The two reasons why the GDP deflator gives a different measure of inflation than the CPI are:

- The GDP deflator uses all final goods and services produced in the domestic economy, while the CPI uses a basket of about 600 goods and services purchased by a typical consumer. This means, for example, that changes in the price of imported goods affect the CPI, but not the GDP deflator. It also means, for example, that changes in the price of domestically produced capital goods affect the GDP deflator, but not the CPI.
- The goods and services in the GDP deflator change every year, while the CPI basket changes only every two years. This matters if relative prices change.