103 F01 Midterm 2 Answer Key

Part A

1 B	2 D	3 D	4 D	5 B	6 B	7 B
8 A	9 B	10 D	11 C	12 D	13 B	14 B
15 A	16 B	17 B	18 C	19 D	20 A	

Part B

1. a. True. The price elasticity of demand for Beetles is 2. That is, a 1% increase in the price would reduce the quantity demanded by 2%. Therefore, a 10% increase in the price would reduce the quantity demanded by 20%.

b. The first part of the statement is true. The income elasticity of demand for Beetles is positive (they are a normal good). That is, an increase in income will increase the demand for Beetles. The demand curve shifts rightward, and the price and quantity of Beetles supplied both increase.

However, the second part of the statement is false. Because both price and quantity increase, regardless of the price elasticity of demand, total revenue will go up. So the statement is false.

2. a. BL1 in the accompanying diagram shows Katya's budget line, and the optimal consumption bundle is labelled A. The optimal consumption bundle is found at the point of tangency between Katya's budget line and her indifference curve.

b. Katya's budget line after the price of public transport has fallen is labelled BL2 in the diagram. The Y-intercept stays the same but the X-intercept moves out away from the origin.

c. Katya's optimal consumption bundle is C. Since public transport is not a Giffen good, we know that as a result of the price fall, Katya's consumption of public transport will increase. (Only if it were a Giffen good would consumption of a good fall as its price falls.)

d. The BLS in the diagram isolates the substitution effect. The move from bundle A to bundle B shows the substitution effect. It tells you that Katya will substitute more public transport for car rides because the relative price (opportunity cost) of public transport has fallen. The move from bundle B to bundle C shows the income effect. Since public transport is an inferior good, the income effect tells you that Katya will consume less public transport as her income rises. For inferior goods, the income and substitution effects work in opposite directions.

