

## Homework Set Three

1. (10%) Vanity Faire has income this period of \$100,000 and expects income next period of \$100,000. She has planned to consume \$80,000 this period. She is now offered a new job, which will only pay her \$50,000 this period but will pay her \$220,000 next period. Will she take it? Explain why or why not. Assume a discount rate of 100%. Explain your reason. And, assume the new job is identical in ALL repeat ALL respects except the salary.
2. (10%) Explain why an increase in wealth need not make someone better off. (Hint: use the two period consumption model).
3. (20%) Explain whether you agree or disagree with the following statements.
  - The life cycle consumption model shows that, both in the long run and in the short run, consumption is proportional to income
  - A bequest motive means that individuals want to leave substantial assets to their children at death
  - A bequest motive does not apply if you want to leave your money to your niece, and not your worthless children.
  - If John's parents book a lavish cruise on the news that John just got a promotion, that means the end of their bequest motive.
4. (10%) Daffy Duck expects to live for four time periods. He expects that income in period 1 of life will be zero, but expects income of \$300,000, \$630,000 and \$240,000 in periods 2, 3 and 4. The interest rate is 50%. Compute Daffy's consumption over his life cycle.

***Hint: Did you use a spreadsheet to compute your answer to the question about Daffy Duck? There will be 10 similar problems in next week's homework. They will be a snap if you have a spreadsheet and a lot of work if you do not. Save your spreadsheet, not just for next week but for subsequent weeks.***

5. (10%) Elmer Fudd expects to live for four time periods, with income of zero in the first and fourth period of life, and income of \$300,000 and \$630,000 in periods 2 and 3 respectively. The discount rate is 50%. At the end of period 2 he decides that Wabbit hunting is great fun and decides that he will not retire at the end of period 3, but work part time in period 4, earning \$240,000 that period. Now compute his consumption and saving

- decisions over his lifetime. Specifically how much will he consume in periods 1, 2, 3 and 4? Compare and contrast Elmer's consumption pattern to Daffy's. What lessons can we learn? And why can't you use your spreadsheet in a mechanical fashion to answer this question?
6. (10%) Horace Jones, a bright young MBA, formerly lived near Cleveland and earned \$60,000 a year. Horace was transferred to New Delhi, India, with no increase in pay. He argued with his boss that the things he purchased in Cleveland would on average cost more in New Delhi and thus he was taking a pay cut. Now, Horace is being transferred back to Cleveland, and finds that the things he purchased in New Delhi cost more here! He has complained bitterly to the Human Resources department of his corporation about this unfairness. Explain why Horace deserves no sympathy.
  7. (10%) If the Heckscher-Ohlin theorem is correct, why would Mexican movie producers, generally very wealthy, be upset by moves to free trade with the US?
  8. (10%) Consider the following statement: A nation that doesn't like to impose tariffs can have the same economic impact on trade by using quotas. Explain why it might be true, and explain where it might go astray.
  9. (5%) In South Wonderland, people each consumed 100 plain and 50 pepperoni pizzas, which sold for 10 Poots and 15 Poots respectively. (At current exchange rates, 1 Poot equals 1 €). In North Wonderland, people each consumed 50 plain and 100 pepperoni pizzas, which sold for 15 Boots and 20 Boots respectively. (At current exchange rates, 1 Boot equals 1 €). Compute each country's per capita consumption in Euros, Poots and Boots. Explain the problems in computing which country had the higher standard of living.
  10. (5 %) Explain how you would have dealt with the comparison problem above if North Wonderland had consumed 50 plain and 100 anchovy pizzas at 15 and 20 boots respectively.