

Homework Assignment #4

Name:

1. Suzie needs to make a decision about how much to consume this year (period 1 - X axis) and next year (period 2 - Y axis). Her income for period 1 is \$500. Her income for period 2 is \$800.
 - a. What are the maximum amount Suzie could consume either this year or next year if the interest rate is 10%?
 - b. What if the interest rate was 5%?

2. Donald has to make a similar decision to Suzie only his income this year is \$1200 and for next year \$100. As in the last question, what are the maximum amounts that Donald can consume this year or next year when the interest rate is 10% and when it is 5%

3. If you were Suzie (from question 1), would you prefer the interest rate to be 5% or 10%? What if you were Donald? Can you think of how the distinction between Suzie and Donald might apply in the real world between retirees and recent college graduates?

4. Draw a graph with Suzie's and Donald's budget constraints when the interest rate is 5%. Draw a second graph of their budget constraints when the interest rate is 10%.

5. Draw indifference curves for Donald and Suzie (labeling them S or D) tangent to their budget lines when the interest rate is 10%. Now mark on their budget lines where their initial endowments are. Is it at the point where the indifference curve touches the budget line? If not, what would Donald and Suzie have to do to get to the point where their indifference curve is tangent to their budget constraint?