

Final Exam - Answer Key

Tuesday, December 16

2 hour, 30 minutes

Name: _____

Instructions

1. This is an open notes exam.
2. No calculators of any kind are allowed.
3. Show all the calculations.
4. If you need more space, use the back of the page.
5. Fully label all graphs.

Good Luck ☺

1. Answer the question based on the following quote from Xenophon (431 – 355 BC): “In small towns the same workman makes chairs and doors and plows and tables, and often the same artisan builds houses...’ whereas in the large cities ‘many people have demands to make upon each branch of industry,’ and therefore ‘one trade alone, and very often even less than a whole trade, is enough to support a man’”. Which principle of economics, attributed to Adam Smith and David Ricardo, is pointed out by Xenophon in the above quote?

Division of labor.

2. What was the main difference between the Mercantilists and the Physiocrats with regards to the role of government?

Physiocrats promoted "**Laissez-faire**", i.e. very little government intervention. Mercantilists advocated lots of regulations, monopoly rights, tariffs and taxes.

3. Explain the importance of the concept of **Pareto Optimality**.

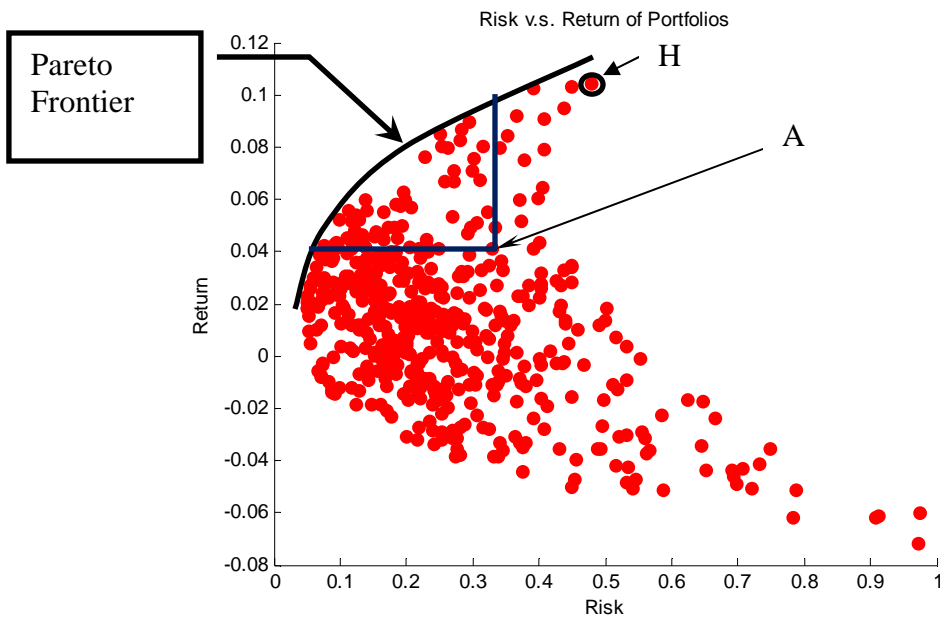
For centuries philosophers tried to figure out what is a **fair** or **just** way to distribute goods in an economy. The problem with fairness and justice is that these criteria are **subjective** - each individual has his own understanding of what is fair and what is just.

Alfredo Pareto designed an **objective criterion** that any desired allocation should possess. The criterion is that all opportunities to make some people better off without making others worse off should be exhausted. This criterion is independent of personal moral principles.

4. Marx concluded that capitalism was unstable because workers do not possess the means of production and are being exploited. Discuss how Becker's concept of **human capital** weakens Marx's conclusion.

If workers possess **human capital** then they are essentially capitalists, which diminished the conflict between the proletariat and capitalists.

5. The following graph depicts 500 randomly generated portfolios in the Risk vs. Return plane.



- Label with "H" the portfolio with the highest return.
- Use your pencil to draw the **Efficient Frontier**.
- Is portfolio labeled "A" efficient? Prove your answer.

A is not efficient portfolio. Any portfolio to the north-west of A (in the cone) gives at least as much return as A, but with lower risk.