I. Supply and Demand
1. In December of 1981, Mexico’s government-owned oil company increased the price for regular gasoline from 38 cents a gallon to 82 cents a gallon. The stated purpose for the price increase was to reduce the rising rate of domestic consumption of gasoline, which had been rising at an annual rate of 14 percent.

A. The accompanying figure shows an equilibrium price of 38 cents. Show how Mexico could raise the price to 82 cents.

B. Is this a decrease in demand or a decrease in quantity demanded? Explain.

C. What could have caused the increase in gasoline consumption prior to the price increase? From the information given, can we tell what caused the price increase?
D. Americans in cities near the Mexican border often traveled to Mexico to buy gasoline because it was cheaper than gasoline in the U.S. Assume that the price of gasoline in the U.S. is $1.00 a gallon when Mexico raises the price from 38 cents to 82 cents. What would be the effect of Mexico’s price increase on the gasoline market in U.S. cities near Mexico?

2. During the energy crisis of the 1970s, many economists predicted severe shortages in oil and other natural resources. These projections were based on trends that existed at that time. These projections showed consumption of oil increasing much faster than production, and indicated severe shortages by the mid-1990s. These shortages have not occurred. Explain why the projected shortages did not take place.

3. A. Suppose David never looks at the menu when he enters his favorite restaurant and always orders 2 eggs for breakfast. What is his price elasticity of demand for eggs? Explain.

B. Suppose Shelley enters a candy store daily and orders $2 worth of licorice. What is her price elasticity of demand for licorice? Explain.
II. Theory of Consumer Choice

4. Demonstrate that an individual’s indifference curves cannot intersect without violating the assumptions concerning consumer preferences.

5. Using the accompanying figure, explain why point B is the market basket chosen by the consumer. Be sure to include in your answer references to all the other points in the figure.

6. At an income of $60,000, Bill chooses not to buy a certain luxury car, but he does choose to buy one at an income of $120,000. If the price of the luxury automobile is $30,000, draw the relevant budget line and indifference curves in the accompanying figure. Be sure to explain your diagram.
III. Individual and Market Demand

7. How are the price-consumption curve and the demand curve related?

8. Explain why the substitution effect is the same whether a good is a normal good or an inferior good.

9. What is a Giffen good? Why do we expect there to be very few Giffen goods?

10. What does the price-consumption curve look like for an inferior good?