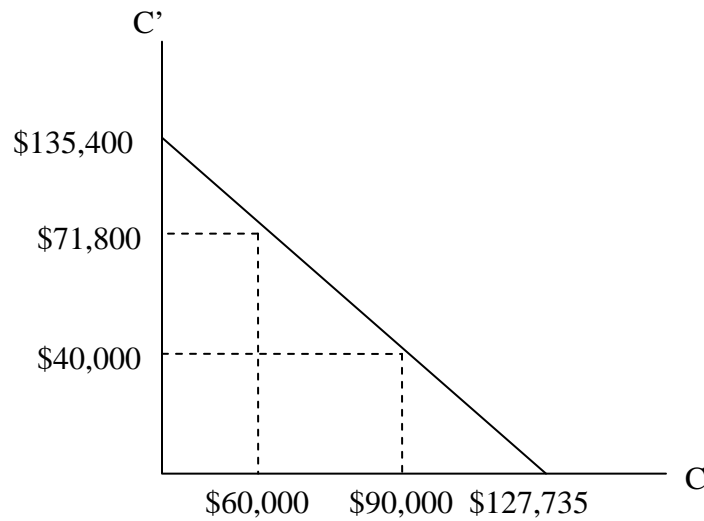


Finance 30220
Quiz #5

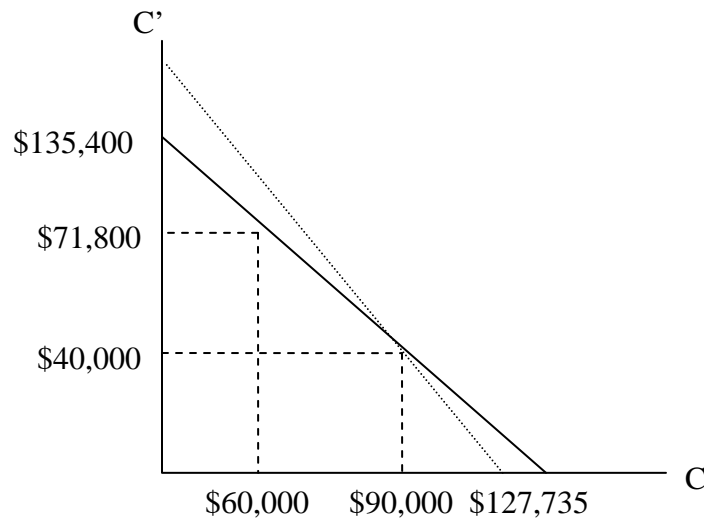
Name _____

Section _____

- 1) Suppose that you are a year away from retirement. You are currently earning \$90,000 per year, but next year, you expect your retirement income to be \$40,000 per year (social security and pension). You can borrow and lend at 6% interest per year.
- a) Sketch your budget line for current and future expenditures. Indicate on your graph a likely consumption choice.



- b) Suppose that the interest rate suddenly increased to 8%. Show the effect of the rise in the interest rate on your budget set. Indicate a new consumption choice on your graph. Explain the reasoning behind your choice. What happens to your savings?



At higher interest rates,

Substitution Effect: Current spending has become more expensive in terms of foregone future spending – consume less, save more.

Income Effect: Higher interest rates effect your wealth: As a saver, you experience a positive wealth effect (higher interest rates raise your interest income) – Consume more, save less.

- c) Suppose that president Bush announces a cut in social security benefits. Explain the impact of this policy change on your savings decision.

If you expect your future income to drop, you should save more today to prepare for it.

- d) Given your answer to (c), what impact would the cut in social security benefits have on interest rates and investment?

Given an increase in savings, the savings curve shifts to the right. Higher savings lowers the interest rate and investment.