KOFA HIGH SCHOOL SOCIAL SCIENCES DEPARTMENT

AP ECONOMICS

TEAM CRITICAL THINKING EXAM - CHAPTER # 20

NAME : *DATE :*

MULTIPLE CHOICE - EACH QUESTION WORTH 4 POINTS

1. * *As nations specialize in production and trade in international markets , they can expect which of the following domestic improvements ?*

   I . *Allocation of domestic resources*

   II . *Standard of living*

   III . *Self – sufficiency*

   A. *I only*

   B. *II only*

   C. *III only*

   D. *I and II only*

   E. *I , II , and III*

2. * *In a flexible system of exchange rates , an open market sale of bonds by the Federal Reserve will most likely change the money supply , the interest rate , and the value of the United States dollar in which of the following ways ?*

	Money Supply	Interest Rate	Value Of The Dollar
A.	Increase	Decrease	Decrease
B.	Increase	Decrease	Increase
C.	Decrease	Decrease	Decrease
D.	Decrease	Increase	Increase
E.	Decrease	Increase	Decrease

*3. *	An inflationary gap can be eliminated by all of the following EXCEPT :*

*A.	An increase in personal income taxes*

*B.	An increase in the money supply*

*C.	An increase in interest rates*

*D.	A decrease in government spending*

*E.	A decrease in net exports*

*4. *	The appropriate monetary policy measure necessary to reach full employment is to increase :*

*A.	The money supply*

*B.	The reserve requirements*

*C.	The discount rate*

*D.	Taxes*

*E.	Exports*

*5. *	According to the monetarists , which of the following is true of expansionary fiscal policy ?*

*A.	It will cause interest rates to rise and crowd out private investment spending*

*B.	It should not be used so long as there is a national debt*

*C.	It should only be used when some resources are unemployed and the inflation rate is low*

*D.	It will decrease aggregate income*

*E.	It will increase aggregate income as long as the money supply is decrease at a slow and steady rate*

*6. *	If the Federal Reserve undertakes a policy to reduce interest rates , international capital flows will be affected in which of the following ways ?*

*A.	Long – run capital outflows from the United States will decrease*

*B.	Long - run capital inflows to the United States will increase*

*C.	Short – run capital outflows from the United States will decrease*

*D.	Short – run capital inflows to the Unites States will decrease*

E. Short – run capital inflows to the United States will not change

*7. * Which of the following policies would most likely be recommended in an economy with an annual inflation rate of 3 percent and an unemployment rate of 11 percent ?*

A. An increase in transfer payments and an increase in the reserve requirement

B. An increase in defense spending and an increase in the discount rate

C. An increase in income tax rates and a decrease in the reserve requirement

D. A decrease in government spending and the open – market sale of government securities

E. A decrease in the tax rate on corporate profits and a decrease in the discount rate

*8. * Which of the following will most likely occur in an economy if more money is demanded than is supplied ?*

A. The amount of investment spending will increase

B. Interest rates will decrease

C. Interest rates will increase

D. The demand curve for money will shift to the left

E. The demand curve for money will shift to the right

SHORT FREE RESPONSE QUESTIONS - 8 POINTS EACH

1. Using monetary and fiscal policies , list the components of an expansionary policy that would encourage long run growth and then explain why the policies will encourage growth.

To encourage long run growth , an expansionary policy should stimulate investment as much as possible .

Monetary policy :

- *Lower discount rate*
- *Lower reserve requirement*
- *Buy bonds on the open market*

These will lower the interest rate and encourage investment

Fiscal policy :

- ***Increase government spending***
- ***Cut business taxes***

This will only be effective if monetary policy can keep interest rates low .

2. ***Explain the effects on long term economic growth of using :***

   A. ***Fiscal policy to fight recession > Using expansionary fiscal policy to fight recession includes lowering taxes and increasing government spending . This strategy will cause crowding – out when government borrowing to cover the budget deficit raises the demand for loanable funds and , hence , interest rates rise . When interest rates rise , investment falls and reduces long run economic growth .***

   B. ***Monetary policy to fight inflation > By using contractionary monetary policy (selling bonds and increasing the federal funds rate) , the Federal Reserve causes a decrease in the money supply . If the demand for money is constant , this new decrease in the money supply will force interest rates further upward , and investment will be lower . When investment falls , long run economic growth is reduced .***

3. ***In a recent year , the United States had a huge balance of trade deficit . Comment on the following policies designed to correct this deficit :***

   A. ***Limit foreign investment by United States firms in other countries > A limit on foreign investment by United States firms would decrease the demand for foreign currencies , so the dollar would appreciate . An appreciated dollar would make United States exports more expensive and worsen the trade deficit .***

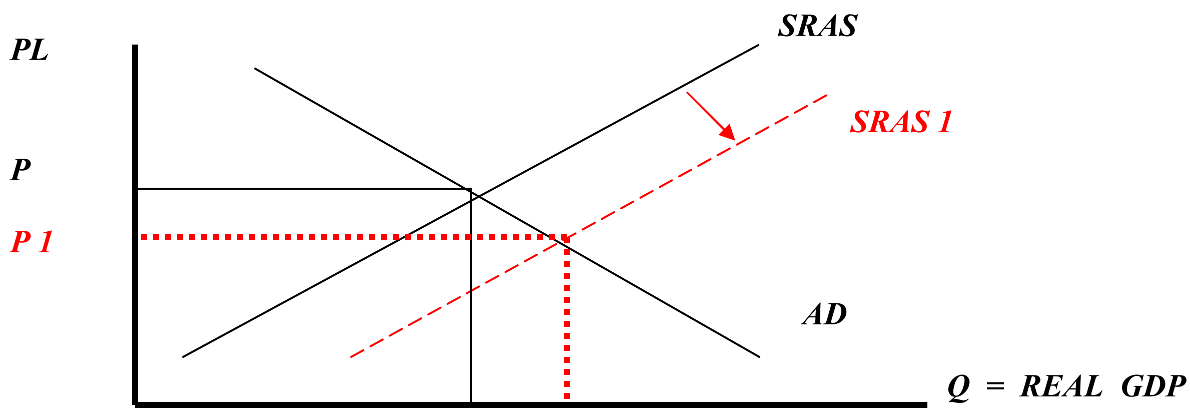
   B. ***Sell dollars so the value of the dollar goes down > Selling dollars would make exports less expensive in foreign countries and*** *imports more expensive in the United States. This would improve the balance of trade.*

4. *Assume that labor in the United States becomes more productive because of major technological changes :*

   A. *Using the aggregate supply and aggregate demand model, explain how the increased productivity will affect each of the following for the United States :*

      1. *Output > The major technological change increases productivity, which causes the aggregate supply curve to shift to the right, resulting in an increase in output and ....*

      2. *Price level > .... decrease in price level.*



      3. *Exports > As a result, United States goods have become less expensive relative to foreign goods, thereby increasing the demand for United States goods = exports increase.*

   B. *Explain how the change in exports you identified in 3 above will affect the international value of the dollar.*

   The increase in exports increases the demand for dollars, which raises the international value of the dollar.

5. *If the rate of inflation is higher in the United States than in other countries, analyze what will happen to :*

   A. *Exports > Will decrease because United States goods will be more expensive relative to foreign goods.*

B. *Imports >* ***Will increase because foreign goods will be less expensive relative to United States goods.***

C. *The international value of the dollar >* ***The dollar will begin to depreciate because Americans will be demanding more foreign currency while foreigners will be demanding fewer United States dollars.***

6. ***Consider the simple model of the world economy in which there are two countries : the United States and South Korea . Both produce cars and computers . The labor requirements for producing each good are below :***

	Labor Hours Required	
	Cars	***Computers***
United States	***80***	***20***
South Korea	***60***	***10***

A. ***Which nation has an absolute advantage in producing cars ? Explain why .***

Korea. Given the same number of hours, Korea can produce more cars than the United States.

B. ***Which nation has a comparative advantage in producing cars ? Explain why .***

United States. It has to give up fewer computers than does Korea to produce each car.

C. ***Explain how the nation with the comparative advantage in producing cars can gain from specialization and trade with the other .***

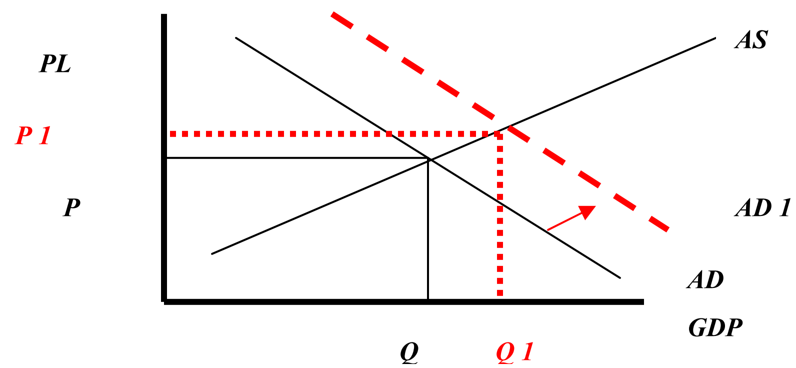
Before specialization and trade , the United States faces a trade – off of one car for four computers. Korea will be willing to trade one car for six computers. Thus, the United States would gain from specializing in producing cars and trading with Korea for computers.

LONG FREE RESPONSE QUESTION - WORTH 20 POINTS

1. *The United States experiences an increase in exports because of changes in the tastes and preferences of foreigners for United States goods . As a result , the following occur :*

- *The real domestic product rises by 3 %*
- *The inflation rate rises from 5 % annually to 10 % annually*
- *The level of unemployment drops from 7 % to 5 %*

A. *Use aggregate demand and supply analysis to explain what has happened in the economy .*



The changes in tastes and preferences of foreigners shifts the AD curve to the right , causing a rise in output and employment and increase in the price level .

B. *Suppose the Federal Reserve decides to sell bonds in the open market . Analyze the short run effects of this action on each of the following :*

1. *Interest rates* > ***The Federal Reserve's sale of bonds causes a decrease in the money supply , which increases the interest rates .***

2. *Output and employment* > ***The increase in interest rates decreases the level of investment , thereby decreasing AD , which causes output and employment to decline .***

3. *Prices* > ***The decrease in AD causes the price level to decline .***

C. *Explain the effects of the change in interest rates caused by the Federal Reserve's action in B above on each of the following :*

1. *The international value of the dollar* > *The increase in interest rates drive the international value of the dollar up as foreigners attempt to invest at the higher rates.*

2. *Imports* > *The increase in the international value of the dollar implies that the United States dollar can purchase more foreign currency, thus the relative price of foreign goods has declined. This causes an increase in the demand for foreign products , and thus imports increase.*

3. *Exports* > *The increase in the international value of the dollar implies that the foreign currency can purchase fewer United States dollars, thus the relative price of United States goods had increased, causing a decrease in the demand for United States goods by foreigners, thus exports decline.*

D. *Now the federal government increases taxes while keeping its expenditures unchanged. Analyze the short run effects of this action on each of the following :*

1. *Output and employment* > *An increase in personal (corporate) taxes reduces disposable income (corporate income) , thus reducing consumption (investment) and decreases AD. Thus, output and employment decrease.*

2. *Prices* > *The decrease in AD results in a price decrease.*

3. *Interest rates* > *An increase in taxes, holding government expenditures constant, is contractionary fiscal policy, resulting in a decrease in interest rates. The decrease in interest rates is because of either a reduction in the government's demand for loanable funds or a fall in the transactions demand for money given the decrease in income.*