

Sample Multiple-Choice Questions

Circle the letter of each correct answer.

- When does the law of comparative advantage indicate that mutually beneficial international trade can take place?
 - When tariffs are eliminated
 - When relative costs of production differ between nations
 - When transportation costs are almost zero
 - When a country can produce a product in less time than another country can
 - When a country can produce more of some product than other nations can
- According to the principle of comparative advantage, worldwide output and consumption levels will be highest when goods are produced in nations where which of the following are true?
 - Opportunity costs are lowest.
 - Absolute advantages are highest.
 - The balance of trade is in a surplus.
 - The exchange rate is falling.
 - The exchange rate is rising.
- What does a balance of trade deficit imply?
 - Exports of goods and services exceed imports of goods and services.
 - Imports of goods and services exceed exports of goods and services.
 - Investment income received from abroad exceeds investment income paid to foreigners.
 - Investment income paid to foreigners exceeds investment income received from abroad.
 - Investment by foreigners exceeds domestic investment in other countries.
- Which of the following transactions represents a deficit in the current account of the U.S. balance of payments?
 - The Moscow Capital Investment Corporation makes a loan to a U.S. firm.
 - A U.S. subsidiary exports raw materials to its French parent company.
 - U.S. firms and individuals receive dividends on U.S. investments in Latin America.
 - U.S. tourists in Great Britain purchase pounds sterling.
 - Foreigners purchase U.S. securities.
- An increase in U.S. interest rates relative to the rest of the world can be expected to
 - encourage investment spending by U.S. firms in the United States.
 - decrease the capital flow into the United States.
 - cause a net outflow of foreign capital from the United States.
 - increase the international value of the dollar.
 - improve the situation for exporters.
- Which of the following is true if a nation does *not* have an absolute advantage in producing any good or service?
 - It cannot have a comparative advantage either.
 - It will have a comparative advantage in the production of the good or service in which it has a lower opportunity cost.
 - It will export raw materials and import finished products.
 - No country will want to trade with this nation because it is not cost effective to do so.
 - The international value of its currency will be fixed.

7. Assume a contractionary monetary policy causes interest rates in the United States to increase relative to Japan. In the short run, the value of the U.S. dollar, the value of the Japanese yen and the U.S. balance of trade will most likely change in which of the following ways?

	Dollar	Yen	U.S. Balance of Trade
(A)	Appreciate	Appreciate	Move toward deficit
(B)	Appreciate	Depreciate	Move toward deficit
(C)	Appreciate	Depreciate	Move toward surplus
(D)	Depreciate	Depreciate	Move toward surplus
(E)	No change	Appreciate	Move toward deficit

8. If a nation's currency appreciates, in the short run its net exports and aggregate demand are most likely to change in which of the following ways?

	Net Exports	Aggregate Demand
(A)	Decrease	Decrease
(B)	Decrease	Increase
(C)	Increase	Decrease
(D)	Increase	Increase
(E)	No change	Decrease

9. If exchange rates are allowed to fluctuate freely and the U.S. demand for Japanese yen increases, which of the following will happen?

- (A) The U.S. balance of trade deficit will worsen in the long run.
- (B) Americans will have to pay more for Japanese goods.
- (C) It will be more expensive for the Japanese to buy American real estate.
- (D) The dollar will appreciate.
- (E) More Americans will want to travel to Japan.

10. If a nation chooses to specialize and trade, which of the following situations could be expected to occur?

- (A) Lower prices
- (B) Fewer domestic jobs
- (C) Decreased resource availability
- (D) Decreased dependence on other nations
- (E) Decreased quantity and quality of goods

Use the information in the following table to answer questions 11 and 12.

The table below shows the amount of cotton and corn per acre that can be produced in each country with one unit of resources.

	Corn	Cotton
Egypt	400 bushels	500 bushels
Venezuela	300 bushels	200 bushels

11. In the absence of international trade, the opportunity cost of producing one bushel of cotton in Egypt is

- (A) 0.8 bushel of corn.
- (B) 1 bushel of corn.
- (C) 1.25 bushels of corn.
- (D) 400 bushels of corn.
- (E) Impossible to determine from the information given.

12. If Egypt and Venezuela begin to engage in bilateral trade, then

- (A) Egypt will export corn and import cotton.
- (B) Egypt will import both corn and cotton.
- (C) Egypt will export both corn and cotton.
- (D) Egypt will import corn and export cotton.
- (E) It is impossible to determine which country will import and export which good.

13. The following data show the quantities of soda and cheese that can be produced in the United States and France with one unit of resources.

	Soda	Cheese
United States	20 bottles	60 pounds
France	10 bottles	40 pounds

Which of the following are true statements?

- I. France has an absolute advantage in producing soda.
 - II. The United States has a comparative advantage in producing soda.
 - III. The United States has an absolute advantage in producing cheese.
 - IV. The United States has a comparative advantage in producing cheese.
- (A) I only
 (B) II only
 (C) II and III only
 (D) II and IV only
 (E) I, II, and III only

14. If the U.S. dollar appreciates in the foreign exchange market, U.S. imports and exports are most likely to change in which of the following ways?

	U.S. Imports	U.S. Exports
(A)	Increase	Remain unchanged
(B)	Increase	Increase
(C)	Increase	Decrease
(D)	Decrease	Remain unchanged
(E)	Decrease	Decrease

15. In the United States, an increase in which of the following will cause an increase in U.S. imports?

- I. Per capita real income
- II. Price level
- III. Interest rates
- IV. Tariffs

- (A) I and II only
 (B) I and III only
 (C) I and IV only
 (D) I, II, and III only
 (E) II, III and IV only

16. The following data show the number of hours it takes in Brazil and Colombia, using one unit of resources, to produce one ton of coffee or one ton of cocoa.

	Coffee	Cocoa
Brazil	5 hours	3 hours
Colombia	6 hours	3 hours

Which of the following statements are true?

- I. Brazil has a comparative advantage in producing coffee.
- II. Colombia has an absolute advantage in producing coffee.
- III. Brazil has an absolute advantage in producing cocoa.
- IV. Colombia has a comparative advantage in producing cocoa.

- (A) I only
 (B) II only
 (C) I and II only
 (D) I and IV only
 (E) I, II and III only

17. Suppose that the price level in Country A increases relative to the price level in other countries. In which of the following ways are Country A's imports and exports most likely to change?

<u>Country A's Imports</u>	<u>Country A's Exports</u>
--------------------------------	--------------------------------

- | | |
|---------------|-----------|
| (A) Increase | No change |
| (B) Increase | Decrease |
| (C) No change | Decrease |
| (D) No change | Increase |
| (E) Decrease | Increase |

18. In the short run, in which of the following ways is an expansionary monetary policy most likely to cause the interest rate and the value of the domestic currency to change?

<u>Interest Rate</u>	<u>Value of Currency</u>
----------------------	--------------------------

- | | |
|---------------|----------|
| (A) Increase | Increase |
| (B) Increase | Decrease |
| (C) No change | Decrease |
| (D) Decrease | Increase |
| (E) Decrease | Decrease |

19. If interest rates in the United States are increasing faster than interest rates in other countries, which of the following is most likely to occur?

- (A) The demand for dollars will decrease, and the value of the dollar will increase.
- (B) The demand for dollars will increase, and the value of the dollar will increase.
- (C) The supply of dollars will decrease, and the value of the dollar will increase.
- (D) The supply of dollars will increase, and the value of the dollar will increase.
- (E) The supply of dollars will increase, and the value of the dollar will decrease.

Sample Short Free-Response Questions

1. 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 U.S. firms in other countries.

(B) Sell dollars so the value of the dollar goes down.

(C) Put high tariffs on autos, steel and consumer electronics.

2. True, false or uncertain, and explain why? “Tariffs actually increase domestic employment by reducing foreign competition and creating more jobs for American workers. Furthermore, more jobs means higher incomes with which Americans can buy more goods from abroad. Hence, instead of reducing foreign trade, tariffs tend to increase it.”

3. Assume that Liechtenstein and Andorra, with equal (and very few) resources, can produce the following:

	Grapes	Wool
Liechtenstein	100,000 kilos	100,000 kilos
Andorra	50,000 kilos	100,000 kilos

- (A) Which nation has an absolute advantage in grapes? Why?
- (B) Which nation has a comparative advantage in grapes? Why?
- (C) Should Liechtenstein specialize in grapes or wool? Why?
- (D) Should Andorra specialize in grapes or wool? Why?
4. True, false or uncertain, and explain why? "If a nation has an expansionary fiscal policy and a contractionary monetary policy, the international value of its currency will appreciate."
- *5. 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.
- (i) Output
 - (ii) Price level
 - (iii) Exports

* Actual free-response question from a past AP test. Reprinted by permission of the College Entrance Examination Board, the copyright owner. For limited use by NCEE.

(B) Explain how the change in exports you identified in (iii) will affect the international value of the dollar.

- *6. Assume that in the United States, nominal wage rates rise faster than labor productivity. Analyze the short-run effects of this situation on each of the following.
- (A) The general price level
 - (B) The level of exports
 - (C) The international value of the dollar

*Actual free-response question from a past AP test. Reprinted by permission of the College Entrance Examination Board, the copyright owner. For limited use by NCEE.

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

(A) exports

(B) imports

(C) the international value of the dollar

8. Consider a simple model of the world economy in which there are two countries: the United States and Korea. Both produce cars and computers. The labor requirements for producing each good are given in the following table.

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

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

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

(C) Show that the nation with the comparative advantage in producing cars can gain from specialization and trade with the other.

Sample Long Free-Response Questions

1. The exchange rate between the Canadian dollar and other currencies has been free to fluctuate since the mid-1960s. For each of the following (in some cases hypothetical) events, indicate whether the value of the Canadian dollar in terms of the U.S. dollar will tend to appreciate, depreciate or remain unchanged. Explain your answer. Use a supply and demand graph to illustrate each situation.

(A) Montreal hosts the Olympics.

(B) The rate of inflation in Canada increases relative to the U.S. inflation rate.

(C) Investors in Quebec purchase substantial real estate in nearby New England and New York.

(D) A consortium of U.S. oil companies constructs a pipeline in Canada to transport natural gas to the United States.

(E) Interest rates rise in the United States relative to interest rates in Canada.

(F) New York and New England utilities contract to buy electricity from Canada's James River hydroelectric facility.

*2. 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 gross domestic product rises by 3 percent.
- The inflation rate rises from 5 percent annually to 10 percent annually.
- The level of unemployment drops from 7 percent to 5 percent.

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

(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.

- (i) Interest rates
- (ii) Output and employment
- (iii) Prices

* Actual free-response question from a past AP test. Reprinted by permission of the College Entrance Examination Board, the copyright owner. For limited use by NCEE.

- (C) Explain the effects of the change in interest rates caused by the Federal Reserve's action in (B) on each of the following.
- The international value of the dollar
 - Imports
 - Exports
- (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.
- Output and employment
 - Prices
 - Interest rates
-

- *3. A series of natural disasters occurs that causes the following changes in the U.S. economy:
- The real gross domestic product drops by 4 percent.
 - The inflation rate rises from 5 percent to 10 percent.
 - Unemployment increases from 6 percent to 10 percent.
- (A) Use aggregate demand and supply analysis to explain what has happened in the economy.
- (B) Suppose that the federal government, holding taxes constant, increases its spending and the Federal Reserve increases its purchases of bonds. Explain in detail the short-run effects of these actions on each of the following:
- (i) Output and employment
 - (ii) Prices
 - (iii) Interest rate
- (C) Explain how exports and imports will be affected by the changes in output and prices resulting from the policies described in (B).

* Actual free-response question from a past AP test. Reprinted by permission of the College Entrance Examination Board, the copyright owner. For limited use by NCEE.

4. Suppose the European Union (EU) has decided to impose trade restrictions on agriculture and some specific manufacturing industries. In fact, the EU has decided to subsidize some agricultural products from small farmers and to increase tariffs and quotas on the following key industries: steel, telecommunications, electronics, machine tools, computers and aerospace. The EU hopes these actions will make Europe less dependent on foreign producers for these essential goods.
- (A) Which groups will gain and which will lose from these proposed restrictions?
- (B) What goals do governments intend to accomplish by imposing trade restrictions?
- (C) What are some of the costs that result from trade restrictions?
- (D) What would be the likely impact of restrictive trade policies on the total amount of trade between the EU and the rest of the world?

(E) Show graphically how quotas, tariffs and subsidies affect trade.

5. Consider a simple model of the world economy in which there are two nations. The United States produces computers and Mexico produces oil.

(A) Suppose now that the Mexican demand for computers increases while the United States' demand for oil remains unchanged. Use a graph to show what would happen to the value of the Mexican peso.

(B) Explain how the exchange rate changes in a flexible exchange rate system.

(C) Explain how this change in the value of the peso affects Mexico's imports and exports.