Chapter 24

Put into practice questions

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Which of the following statements are true and which are false? Explain your answers.

a. Export spending is an injection into an economy. TRUE
b. An increase in export spending reduces aggregate demand. FALSE
c. If a currency is cheap, this is likely to increase exports. TRUE
d. Higher incomes domestically lead to an increase in exports. FALSE

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Consider two economies X and Y, for which the outputs produced of products A and B are as shown. Calculate the opportunity cost of each product for each country.

Opportunity costs:

Country X	Product A is 1/3 B	Product B = 3A
Country Y	Product A is 3/2 B	Product B = 2/3A

Identify which product each country would specialize in and the total output if all of the resources focus on this industry.

Country X specialize in A as it has lower opportunity cost
Country Y specialize in B as it has lower opportunity cost

What has happened to the world output of A and B as a result of specialization and trade?

If countries specialize
Country X 12 As
Country Y 6 Bs
This means world output increases by 4 As and 1 B

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Would you accept any country that wants to join the EU? Why? Or why not?

Would depend on e.g if it met trading rules, had aligned on regulations and would not destabilise European Union economy

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Show how trade can enable an economy to consume outside of its production possibility frontier

See figure 2.5

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Imagine that a UK firm produces a product for £200. What would the price in dollars be:

- If the exchange rate is $1.5: £1? $300
- if the exchange rate is $2: £1? $400

Suppose that the original level of sales was 500 units and then sales fell to 450 units.

Calculate the original and new value of sales in dollars.

Original value = 500 * $300= $15,000
New value= 400* $400 = $16000

Calculate the original and new value of sales in pounds.

Original value = 500 * £200= £10,000
New value= 400* £200 = £8,000

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The exchange rate appreciates from $1.5: £1 to $2:£1. The US price of a product is $300. A UK consumer buys 20 units initially and then, when the exchange rate changes, 40 units. What happens to the amount of pounds spent on this import?

UK price was = $300/$1.5 = £200
UK price is = $300/$2= £150
Spending was = £200 * 20 = £4000
Spending is = £150 * 40 =£6000

The US dollar devalues by 10 per cent and US firms keep the dollar price of their exports the same. The price elasticity of demand for US exports is −0.5. What will happen to US export earnings?

The answer is E: They will rise by about 5 per cent.

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Which of the following statements are true and which are false?

a. Each country has one exchange rate. FALSE
b. An increase in domestic interest rates is likely to increase the value of the currency. TRUE
c. High domestic inflation is likely to increase the value of the currency. FALSE
d. A fall in the value of a currency makes its exports cheaper in foreign currencies, all other things being equal. TRUE

Which of the following are not likely to lead to a fall in the external value of the pound?

a. a fall in UK interest rates. Likely to
b. more spending by overseas tourists in the UK. Not likely to.
c. UK citizens buying more imported cars. Likely to.
d. an increase in UK aid to developing countries Likely to.
e. an increase in UK military spending abroad. Likely to

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If there is an increase in UK interest rates this is most likely to cause the UK exchange rate to appreciate because:

Of increased inflows of hot money

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The value of the pound against the US dollar changes from £1 = $2.00 to £1 = $1.50. All other things being equal, this is most likely to result in

An increase in UK exports and a higher inflation rate in the UK

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Outline two ways in which a government might reduce the value of its currency. Show this using supply and demand analysis.

The government might sell its own currency- increasing supply
The government or central bank might reduce interest rates reducing demand.

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Which of the following statements are true and which are false?

a. An increase in demand for a currency is likely to lead to an appreciation of the currency in a floating exchange rate. TRUE
b. To increase the value of its currency, a government might sell its foreign currency reserves. FALSE; this increases supply and reduces its value
c. A decrease in supply of a currency to the currency markets is likely to decrease its value. FALSE; it's likely to increase its value

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d. A floating exchange rate makes planning more difficult than a fixed exchange rate TRUE as it is varying affects export prices and import costs.

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Which of the following statements are true and which are false?

a. All members of the EU have the euro as their currency. FALSE
b. If the pound falls in value against the euro, the euro must rise in value against the pound. TRUE
c. Higher interest rates in Eurozone countries are likely to lead to an increase in the value of the euro. TRUE; demand for the currency will increase all other things equal
d. If the euro is weak, this makes goods from these countries expensive in foreign countries, all other things unchanged. FALSE; makes them cheaper

End of chapter put into practice questions

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What is the opportunity cost of each product in each country?

Opportunity costs

Country X	1A= 2/5 B	1B= 2 ½ A
Country Y	1A=2/3B	1B= 1 ½

Which product would each country specialize in?

Country X could specialize in A
Country Y could specialize in B

If the opportunity cost of 1A is 3B in one country and 5B in another country calculate the possible terms of trade.

3B < 1A < 5B

Which of the following will cause a favourable movement in the terms of trade?

Answer is C:. Prices of imports rise by less than export prices

The government wants its currency to appreciate. What is the best policy to adopt? Explain.

Answer is A: Increase interest rates

The devaluation of a currency will always:

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Answer is B:. worsen the terms of trade

The value of the pound falls from 1.2 euros to 1.1 euros. Calculate the impact on the euro price of a product that sells for £20,000.

Price falls from 24000 euros to 22000 euros

Explain the likely effect of an increase in interest rates on the value of a currency.

Higher interest rates attract funds from abroad. This increases demand for currency and increases its value.

Using diagrams show the possible effect of a falling value of the pound on national income and prices.

If the pound falls in value against other currencies this can stimulate exports and reduce imports. This boosts aggregate demand shifting demand outwards. This increases prices and output.

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