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Test Items
Chapter 2 – National Income and the Balance of Payments Accounts

True/False Questions

1. The national output of a nation includes payments of wages, rents, profits, and interest to workers and owners of capital and property.
   False; Moderate

2. In the circular flow of money diagram, goods and services move between firms to households in a counterclockwise direction.
   True; Easy

3. The GDP of a nation measures the value of both intermediate as well as final goods and services.
   False; Easy

4. Consider a German resident owning a factory in the U.S. The fraction of the production that accrues to the German owner would be included in the U.S. GNP but not the U.S. GDP.
   False; Moderate

5. In a country witnessing inflation, GDP growth is likely to overstate the growth of the standard of living.
   True; Easy

6. The private domestic investment component of GDP includes financial investments made by individuals or businesses.
   False; Easy

7. A subsidy provided by the government of a country to an infant industry will be included in the government expenditure component of the GDP.
   False; Easy

8. Receipts and payments of factor income and transfer payments to the rest of the world are included in the net exports component of the GDP.
   False; Moderate

9. Imports are always subtracted from the GDP because they represent a cost to the economy.
   False; Easy

10. Nominal GDP in the U.S. was a little over $14 trillion in 2008.
    True; Easy

11. The share of gross private domestic investment in the U.S. GDP fell in 2008 from its year ago level reflecting the slide into the economic recession.
    True; Easy

12. The large stimulus package provided by the government to revive the U.S. economy from recession is by itself sufficient to assure higher growth.
    False; Easy

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13. Most of the federal spending in 2008 was on defense-related goods and services
True; Easy

14. The financial account of the balance of payments (BoP) records all international transactions for goods and services, income payments and receipts, and unilateral transfers.
False; Easy

15. When a Japanese company owns an office building in the United States and brings back to Japan a share of the profit earned there as a part of its income, then this is classified as an income receipt on the current account of the United States' balance of payments.
False; Moderate

16. A financial aid provided by the U.S. to a Tsunami affected country will be recorded both as a debit as well a credit entry in the BoP accounts.
False; Moderate

17. The goods and services trade balance is a narrow measure of trade between countries encompassing only traded goods.
False; Easy

18. Assets consisting ownership shares in a business involve a contractual obligation to repay principal plus interest.
False; Easy

19. Whenever a good, service, or asset is exported from a country, the value of that item is recorded as a debit entry on the balance of payments.
False; Easy

20. Each transaction between a U.S. resident and a foreign resident would result in an entry on both the domestic and the foreign balance of payments accounts.
True; Easy

21. When a U.S. investor invests in some Chinese stocks, the transaction will be recorded in the financial account of the U.S. balance of payments.
True; Moderate

22. When a Japanese resident exchanges ¥56,000 for $500 the transaction will be recorded on the financial account of Japan's BoP.
False; Moderate

23. When the financial account of a country reports a surplus, it implies that the imports of assets have exceeded the exports of assets.
False; Easy

24. Imbalances on a current account, a trade account, or a financial account do not represent unequal exchanges, or inequities, between countries.
True; Easy

25. Income receipts on U.S. assets abroad is included in the U.S. GNP but excluded from the U.S. GDP.
True; Easy

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26. The United States recorded a current account deficit of $706 billion in 2008.
True; Easy

27. When a country records a financial account surplus, it implies foreigners are buying more domestic assets than domestic residents are buying foreign assets.
True; Easy

28. The primary source of statistical discrepancy in the BoP data are the transactions recorded on current account side.
False; Moderate

29. The sum of household and business saving in an economy always exceeds investment.
False; Easy

30. Government expenditures that do not exchange for a particular good or service are usually referred to as transfer payments.
True; Easy

31. When the tax revenue collected by the government exceeds its expenditure and transfer payments, public saving is positive.
True; Easy

32. The sum of household, business, and government saving in an economy must equal private investment expenditures.
True; Easy

33. The U.S. is called a creditor nation because its domestic liabilities to foreigners exceed domestic assets.
False; Moderate

34. Given the inflation rate in a country is higher than expected, while the nominal interest rate is fixed, the real value of a debt repayment will be higher than originally expected.
False; Moderate

35. Suppose during a certain year the U.S. currency depreciates. The value of the repayments in dollars will rise for an U.S. citizen who had borrowed funds from a Chinese bank.
True; Easy

36. If the foreign currency in which assets owned by a U.S. investor are denominated falls substantially in value, then the value of those assets fall along with it.
False; Easy

Multiple Choice Questions

1. _____ represents the market value of all goods and services produced by firms in a country.
   a. National product
   b. Domestic product
   c. National income
   d. Balance of payment

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e. Disposable income
a; Easy

2. In the simple circular flow of income model:
   a. dollars flow from firms to households in a counterclockwise direction.
   b. factor services move from households to firms in a counterclockwise direction.
   c. goods and services move from firms to households in a clockwise direction.
   d. factor services move from households to firms in a clockwise direction.
   e. goods and services move from households to firms in a clockwise direction.
   b; Easy

3. _____ measures the monetary flow along the top part of the simple circular flow diagram.
   a. Net disposable income
   b. Gross domestic product
   c. National product
   d. National income
   e. Balance of trade
   c; Moderate

4. Which of the following economic transactions will be recorded in the U.S. GDP but not in the U.S. GNP?
   a. Purchase of semi-finished auto parts by an automobile manufacturer in Florida from a local dealer.
   b. Profit earned by a U.S. multinational's subsidiary in Indonesia.
   c. Aid provided by the U.S. government to earthquake affected victims in Haiti.
   d. Uncut diamonds purchased by a large jewelry manufacturer in Washington D.C.
   e. Production at a factory located in Ohio owned by a Japanese multinational.
   e; Easy

5. The _____ of a country measures all production achieved by domestic factors of production regardless of where that production takes place.
   a.
   b. Net national product
   c. Gross national product
   d. Gross domestic product
   e. Net disposable income
   c; Easy

6. When the GDP of a nation falls significantly over a long term a country is said to be experiencing:
   a. stagflation.
   b. a BoP imbalance.
   c. a depression.
   d. a recession.
   e. an economic stagnation.
   d; Moderate

7. National wealth is said to be a better indicator of national economic well-being than GDP because:
   a. it gives an account of how the national income is distributed among members of the economy.

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b. it measures the value of all goods, services, and assets available in an economy at a point in time
c. it measures the value of goods and services produced during the current year.
d. it measures the value of both intermediate and final goods and services produced in a country.
e. it measures the value of goods and services produced by domestically owned factors of production.

b; Easy

8. GDP can be used to provide a rough estimate of the average standard of living among individuals in the economy and for making cross-country comparisons only when it is divided by:
a. the unemployment rate.
b. the average interest rate.
c. the total population in the economy.
d. the annual rate of inflation.
e. the exchange rate.

c; Easy

9. Real GDP is used while computing the growth rate of GDP because:
a. it eliminates some of the inflationary effects.
b. it gives an account of income distribution in the economy.
c. it helps to calculate the value added at each stage of production of a good or a service.
d. it eliminates double counting of goods and services produced in a country.
e. it indicates the fiscal health of a nation.

a; Easy

10. Which of the following activities will generate a negative production externality?
a. A person smoking cigarettes while waiting to catch a bus.
b. A builder planting trees on each side of the road leading to a multi-storey.
c. The government increasing its planned outlay on Medicare and Medicaid programs.
d. A fertilizer plant releasing its wastes/byproducts into an adjacent river.
e. A coffee manufacturer opening up a new facility in the remote locality of a small town.

d; Moderate

11. Which of the following will be included under private domestic investment in the GDP of the U.S. for 2008?
a. A U.S. citizen purchasing a pre-owned property constructed in 2006.
b. A two-storey house purchased by a U.S. citizen in 2007.
c. A businessman purchasing a newly constructed office building in 2008.
d. A retired U.S. citizen selling off his property which he had purchased in 2005.
e. A property owner expending on repair and maintenance of an existing building in 2008.

c; Moderate

12. Which of the following can be categorized as a nonresidential investment in the U.S. GDP?
a. A U.S. investor purchasing adding new stocks to her asset portfolio.
b. A couple planning to construct a new house on their existing plot of land.
c. A U.S. investor purchasing a British certificate of deposit.
d. A U.S. citizen selling off his existing house to purchase a mobile home.
e. A beverage plant in Florida purchasing hi-tech machinery from a German company to increase production.

e; Moderate

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13. Which of the following items will NOT be included under government expenditures in GDP accounting?
    a. Expenditure on wheat procurement from cultivators at the rate guaranteed by a price floor.
    b. Expenditure on agricultural subsidy.
    c. Expenditure on infrastructural development.
    d. Expenditure on public health and security.
    e. Expenditure on higher education.
    b; Moderate

14. Which of the following can be classified as a government transfer payment?
    a. Tuition payments for higher education
    b. Compensation paid to government employees
    c. Government medical insurance payments
    d. Expenditure on national defense
    e. Government expenditure on the repair and maintenance of roads.
    c; Easy

15. Which of the following items are excluded from the net exports component in GDP accounts to maintain the definition of a trade balance?
    a. Import of durable commodities
    b. Export of perishable commodities
    c. Investments in foreign stocks
    d. Net factor income from the rest of the world
    e. Government transfer payments
    d; Moderate

16. Imports are subtracted in the national income identity because:
    a. they represent a cost to the government.
    b. they represent an opportunity cost to the economy.
    c. they appear in the identity as hidden elements in consumption, investment, government, and exports
    d. they slacken the GDP growth of a country.
    e. they increase the rate of unemployment in the country.
    c; Easy

17. The U.S. economy was the largest in the world in 2008, because:
    a. its annual nominal GDP was about $14 trillion.
    b. the U.S. government expenditure had amounted to $2.9 trillion.
    c. gross private domestic investment was over $2 trillion.
    d. personal consumption expenditures were over $10 trillion.
    e. total U.S. imports were more than $2.5 trillion.
    a; Easy

18. Between 2007 and 2008, the United States added over _____ to its GDP.
    a. $600 billion
    b. $250 billion
    c. $2.5 trillion
    d. $800 billion
    e. $5 trillion
    a; Easy

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19. _____ were the largest component of U.S. GDP, making up about 70 percent of output in 2008.
    a. Gross private domestic investment
    b. Gross exports
    c. Government expenditures
    d. Consumption expenditures
    e. Gross imports
    d; Easy

20. Which of the following was the largest component of personal consumption expenditures in the U.S. GDP in 2008?
    a. Durable goods
    b. Services
    c. Nondurable goods
    d. Nonresidential investment
    e. Change in business inventories
    b; Easy

21. The fall in the share of gross private domestic investment in the U.S. GDP in 2008 reflects:
    a. the poor state of fiscal health.
    b. the expected surge in consumption expenditure in the near future.
    c. the sudden rise in the rate of inflation in the U.S. economy.
    d. the overall increase in the demand for U.S. exports across the world.
    e. the slide of the U.S. economy into the economic recession.
    e; Moderate

22. The most direct impact of the large government stimulus package announced by the U.S. government in 2009 will be on:
    a. residential investment.
    b. total government expenditure.
    c. gross imports.
    d. net exports.
    e. gross expenditure on nondurable goods.
    b; Easy

23. Refer to the data on the U.S. GDP for 2007-2008 to identify the correct statement.
    a. The state and local spending was almost twice the level of federal spending.
    b. Most of the federal spending was on public health and sanitation.
    c. Exports as a percentage of GDP declined in 2008 from its year ago level.
    d. Private domestic investment expenditures were the largest component of the U.S. GDP.
    e. Gross private domestic investment remained relatively constant over time.
    a; Moderate

24. In terms of the dollar value of trade, _____ is the largest importer and exporter of goods and services in the world, but trades less as a percentage of GDP relative to many other countries.
    a. Japan
    b. the European Union
    c. Ireland
    d. the United States
    e. China
    d; Easy

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25. The _____ is a record of all international transactions that are undertaken between residents of one country and residents of other countries during the year.
    a. balance of payments
    b. balance of trade
    c. fiscal balance
    d. gross national product
    e. gross national income
    a; Easy

26. Which of the following transactions will be recorded on the financial account of the balance of payments (BoP)?
    a. International transactions related to income payments and receipts.
    b. International transactions related to unilateral transfers.
    c. International transactions related to foreign aid.
    d. International transactions related to the purchase of goods and services
    e. International transactions related to the purchase and sale of Treasury bills.
    e; Easy

27. Which of the following transactions will be recorded on the current account of the balance of payments (BoP)?
    a. International transactions related to the purchase and sale of Treasury bills.
    b. International transactions related to the purchase and sale of stocks.
    c. International transactions related to unilateral transfers.
    d. International transactions related to the purchase and sale of currency.
    e. International transactions related to the purchase and sale of real estate.
    c; Easy

28. Which of the following transactions will be recorded in the services account of the BoP?
    a. Export of semi finished auto parts
    b. Legal and consulting charges paid to an international law firm.
    c. Import of hi-tech computer appliances
    d. Purchase of foreign certificate of deposit
    e. Investment in real estate in a foreign country
    b; Easy

29. Identify the correct statement.
    a. When the total export of goods and services exceed the total import, there is a merchandise account deficit.
    b. When the total export of goods and services exceed the total import, there is a current account deficit.
    c. When the total export of goods and services exceed the total import, there is a financial account deficit.
    d. When the total export of goods and services exceed the total import, there is a financial account surplus.
    e. When the total export of goods and services exceed the total import, there is a current account surplus.
    e; Moderate

30. _____ represent the money earned by domestic residents on their investments abroad.
    a. Income receipts
    b. Merchandise balances

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c. Unilateral transfers
d. Foreign aids
e. Net exports
a; Easy

31. _____ are payments that are made or received that do not have an offsetting product flow in the opposite direction.
a. Government subsidies
b. Income payments
c. Unilateral transfers
d. Stock market investments
e. Bank loans
c; Easy

32. Which of the following is included in GNP but not in the GDP of a country?
a. Export of services
b. Government subsidies
c. Stock market investments
d. Unilateral transfers
e. Bank deposits
d; Easy

33. Which of the following rules in BoP accounting is true?
a. When a good is exported from a country it will be entered as a credit entry in the current account.
b. When a good is imported by a country it will be entered as a credit entry in the current account.
c. When a service is imported by a country it will be entered as a credit entry in the financial account.
d. When a service is exported by a country it will be entered as a credit entry in the financial account.
e. When a good is imported by a country it will be entered as a debit entry in the financial account.
a; Easy

34. Suppose a U.S. tourist intends to purchase a digital SLR camera priced at ¥18,000 from Japan for which he needs to exchange dollars for rupees at a spot exchange rate of 85.32¥/$. Which of the following entries will be made on the U.S. BoP to account for this currency exchange?
a. The current account of the U.S. BoP will be credited with $210.97.
b. The financial account of the U.S. BoP will be credited with $210.97.
c. The current account of the U.S. BoP will be debited with $210.97.
d. The financial account of the BoP will be debited with $210.97.
e. The financial account of the BoP will debited with ¥85.32.
b; Easy

35. Which of the following relationships must be satisfied in the BoP accounting system?
a. Financial account balance - current account balance = 0.
b. Current account balance ÷ financial account balance = 0.
c. Current account balance × financial account balance = 0.
d. Current account balance - financial account balance = 0.
e. Current account balance + financial account balance = 0.

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e; Easy

36. The balance of payment identity is valid only if:
    a. countries report the measured values of their trade balances.
    b. countries impose trade restrictions.
    c. only if the goods and services imported by a country remains static over time.
    d. countries report the actual current account and financial account balances.
    e. countries follow free trade.
    d; Moderate

37. _____ represents the amount that must be added or subtracted to force the measured current account balance and the measured financial account balance to zero.
    a. Merchandise balance
    b. Random error
    c. Statistical discrepancy
    d. Trade deficit
    e. Unfair trade
    c; Easy

38. An imbalance on a country's current account implies:
    a. an equal but opposite imbalance on the financial account.
    b. a balance on the merchandise trade account.
    c. a balance on the financial account.
    d. an unequal exchange between the domestic country and all other foreign countries.
    e. an income inequality between the domestic country and all other foreign countries.
    a; Easy

39. A _____ surplus means that foreigners are buying more of our assets than we are buying of theirs.
    a. merchandise trade account
    b. current account
    c. goods & services account
    d. financial account
    e. services account
    d; Easy

40. All components of transactions that involve _____ are recorded on the financial account of the BoP.
    a. unilateral transfers
    b. income receipts
    c. assets
    d. goods
    e. services
    c; Easy

41. Consider the following balance of payments (BoP) statistics for the country Norwick in the year 2009.
    Exports of merchandise goods: $345 billion
    Imports of merchandise goods: $240 billion
    Income receipts on Norwick's assets abroad: $60 billion
    Aid received from the World Bank: $250 billion
    Compute current account balance of this country for the year 2009.

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a. $655 billion
b. $415 billion
c. $105 billion
d. $165 billion
e. $595 billion
b; Moderate

42. The direct investment receipts mentioned in the U.S. BoP statement represents:
a. the unilateral transfer of funds from the U.S.
b. the purchase of U.S. assets by the foreign companies.
c. the new investments made by the U.S. companies in foreign countries.
d. profit earned by the U.S. companies on foreign direct investment (FDI).
e. dividend earned by foreign companies holding U.S. assets.
d; Moderate

43. The U.S. BoP statistic for the year 2008 shows unilateral transfers as a debit entry. This implies:
a. more transfers are made from the U.S. to individuals abroad.
b. more transfers are made to the U.S. from individuals abroad.
c. U.S. investors have earned a higher rate of return on foreign assets.
d. U.S. companies have invested in large number of foreign stocks.
e. the U.S. government has bought back some Treasury bonds.
a; Easy

44. Which of the following transactions measure the extent of participation of central banks to maintain a fixed exchange rate and is sometimes referred to as "balance of payments" in a fixed exchange rate system?
a. Direct investment receipts
b. Income payments on foreign assets
c. Direct investment payments
d. Net capital account transactions
e. Net U.S. official reserve transactions
e; Easy

45. In 2008, the United States recorded a current account deficit of _____.
a. $144 billion
b. $840 billion
c. $810 billion
d. $706 billion
e. $760 billion
d; Easy

46. Identify the correct statement.
a. In 2008, the United States recorded a trade deficit of $750 billion.
b. In 2008, the United States recorded a service surplus of over $144 billion.
c. In 2008, there was a recorded investment income deficit of over $118 billion in the United States.
d. In 2008, the United States recorded a goods and services trade surplus of over $695 billion.
e. In 2008, the United States recorded a financial account deficit of over $533 billion.
b; Moderate

47. In 2008, the size of the U.S. statistical discrepancy was:

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a. $200 billion
b. $400 billion
c. $800 billion
d. $600 billion
e. $450 billion
a; Easy

48. The primary source of statistical discrepancy in the U.S. is said to be on the capital account side rather than the current account side because:
    a. service and income transactions on the current account can be easily monitored.
    b. current account data are acquired through surveys completed by major banks and financial institutions.
    c. current account data is measured directly and completely by customs officials.
    d. asset trade is tangible and easy to monitor.
    e. goods transactions are accomplished electronically and are thus always accurate.
    c; Easy

49. The _____ is a term in reference to a country's government budget deficit and a simultaneous current account deficit.
    a. national income identity
    b. twin-deficit identity
    c. balance of payment identity
    d. balance of trade identity
    e. current account identity
    b; Easy

50. The fraction of an extra dollar of income than an individual spends on consumption goods is called:
    a. the average consumption expenditure.
    b. the opportunity cost of consumption.
    c. the marginal propensity to investment.
    d. the marginal propensity to consume.
    e. the marginal propensity to save.
    d; Easy

51. _____ is all the portion of income left with households to spend on consumption or investment after paying taxes.
    a. Net national product
    b. Real GDP
    c. Net private investment
    d. Net national income
    e. Disposable income
    e; Moderate

52. In Circular Flow: Version 2, financial institutions divert money from the circular consumption flow in the form of:
    a. government saving.
    b. government transfers.
    c. business consumption.
    d. household savings.
    e. household consumption.

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d; Easy

53. Given S_P is the total private saving, I is the investment spending, G is government expenditure, TR represents the government transfer payment, T represents the tax receipts, and (IM-EX) represents the net exports of a country, the twin-deficit identity will be represented as:
    a. $(S_P - I) = (G - TR - T) - (EX - IM)$.
    b. $(S_P - I) = (G + TR - T) - (IM - EX)$.
    c. $(S_P - I) = (G + TR - T) + (IM - EX)$.
    d. $(S_P - I) = (G - TR - T) - (IM - EX)$.
    e. $(S_P - I) = (G + TR + T) - (IM - EX)$.
    b; Easy

54. Given S_P is the total private saving, I is the investment spending, G is government expenditure, TR represents the government transfer payment, T represents the tax receipts, and (IM-EX) represents the net exports of a country, and $(S_P - I) + (IM - EX) = (G + TR - T)$ is the twin deficit identity. If $(IM - EX) > 0$ we can say that:
    a. the country has a capital account deficit.
    b. the country has a government budget surplus.
    c. the country has a current account deficit.
    d. the country has a current account surplus.
    e. the private investment saving in this country is positive.
    c; Easy

55. The international asset position (IIP) of a country:
    a. is a balance sheet that shows the total holdings of foreign assets by domestic residents at a point in time and the total holdings of domestic assets by foreign residents at a point in time.
    b. consists of flow variables since it records changes in the country's asset holdings during the year.
    c. is an income statement that shows the changes in asset holdings during the past year.
    d. consists of flow variables since it records the total value of assets at a point in time.
    e. is always in balance.
    a; Moderate

56. Which of the following is true of equity obligations?
    a. They establish an obligation for the borrower to repay principal and interest in the future.
    b. They represent ownership shares in potentially productive assets.
    c. They consist of a contract agreeing to an initial transfer of money between the lender and the borrower.
    d. They record the changes in the individual asset holding at a point in time.
    e. They do not transfer the advantages and disadvantages of the asset to its holder.
    b; Easy

57. According to preliminary estimates, in 2008, the U.S. was in debt to the rest of world in the amount of:
    a. $2.46 trillion.
    b. $4.69 trillion.
    c. $3.469 trillion.
    d. $5.469 trillion.
    e. $3.96 trillion.
    c; Easy

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58. Identify the correct statement.
    a. The sum total value of foreign assets owned by U.S. residents in 2008 was below $10 trillion.
    b. The sum total of U.S. assets owned by foreigners in 2008 was more than $30 trillion.
    c. The sum total of U.S. assets owned by foreigners in 2008 was less than $10 trillion.
    d. The sum total of U.S. assets owned by foreigners in 2008 was more than $20 trillion.
    e. The sum total value of foreign assets owned by U.S. residents in 2008 was more than $25 trillion.

    d; Easy

Short Answer Questions

1. What is the difference between the national product and national income?
   National income represents the total amount of money that factors of production earn during the course of a year. This mainly includes payments of wages, rents, profits, and interest to workers and owners of capital and property. The national product refers to the value of output produced by an economy during the course of a year.
   Easy

2. Why are imports subtracted in the national income identity?
   Imports are subtracted in the national income identity because imports appear in the identity as hidden elements in consumption, investment, government, and exports. Imports must be subtracted to assure that only domestically produced goods are being counted.
   Easy

3. Why is the investment component of GDP often the target of considerable concern in the United States?
   Investment represents how much the country is adding to the capital stock. Since capital is an input into production, in general the more capital equipment available, the greater will be the national output. Thus investment spending is viewed as an indicator of future GDP growth. Perhaps the higher is investment, the faster the economy will grow in the future.
   Moderate

4. What are the two subcomponents under the current account of the balance of payment (BoP) accounts?
   The current account is often further subdivided into the merchandise trade account and the service account.
   Easy

5. What are the two simple rules of thumb used to classify entries on the balance of payments accounts?
   There are two simple rules of thumb to help classify entries on the balance of payments:
   a) Any time an item (good, service, or asset) is exported from a country, the value of that item is recorded as a credit entry on the balance of payments.
   b) Any time an item is imported into a country, the value of that item is recorded as a debit entry on the balance of payments.
   Moderate

6. What is the implication of the $200 billion statistical discrepancy recorded by the U.S. BoP statistics in 2008?

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The U.S. BoP statistics recorded a statistical discrepancy worth $200 billion in 2008. This implied that recorded debit entries on the balance of payments exceeded recorded credit entries. Thus an additional $200 billion credit entry was needed to make the accounts balance. The presence of a statistical discrepancy means that there are international transactions that have taken place but have not been recorded or accounted for properly.
Easy

7. When does a country witness twin deficits?
Twin deficits occur when a country has both a current account deficit and a government budget deficit at the same time.
Moderate

8. Why is the U.S. referred to as the largest debtor nation of the world?
The United States is the largest debtor nation in the world. This means that its international investment position is in deficit and the monetary value of that deficit is larger than that of any other country in the world.
Easy

Essay

1. List some of the weaknesses of GDP as a measure of the economic well-being of a nation.
The weaknesses of GDP as a measure of the economic well-being of a nation are as follows:
a) GDP only measures the amount of goods and services produced during the year. It does not measure the value of goods and services left over from previous years.
b) GDP, by itself, fails to recognize the size of the population that it must support. If we want to use GDP to provide a rough estimate of the average standard of living among individuals in the economy, then we ought to divide GDP by the population to get per capita GDP. This is often the way in which cross-country comparisons are made.
c) GDP gives no account of how the goods and services produced by the economy are distributed among members of the economy.
d) Measured GDP growth may overstate the growth of the standard of living since price level increases (inflation) would raise measured GDP. For this reason, real GDP is typically used to measure the growth rate of GDP.
e) Sometimes, economies with high GDPs may also produce a large amount of negative production externalities. Pollution is one such negative externality. Thus one might prefer to have a lower GDP and less pollution than a higher GDP with more pollution. Some groups also argue that rapid GDP growth may involve severe depletion of natural resources, which may be unsustainable in the long run.
f) GDP often rises in the aftermath of natural disasters, mostly because of the surge of construction activities required to rebuild the damaged buildings. This illustrates why GDP growth may not be indicative of a healthy economy in some circumstances.
g) GDP measures the value of production in the economy rather than consumption, which is more important for economic well-being.
Easy

2. Briefly describe the personal consumption expenditure, private domestic investment and government expenditure component of the GDP.
GDP is the sum of personal consumption expenditures (C), private investment expenditures (I), government consumption expenditures (G), and expenditures on exports (EX) minus expenditures on imports (IM): GDP = C + I + G + EX − IM.

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Personal consumption expenditures (C), or "consumption" for short, include goods and services purchased by domestic residents. These are further subdivided into durable goods, commodities that can be stored and that have an average life of at least three years; nondurable goods, all other commodities that can be stored; and services, commodities that cannot be stored and are consumed at the place and time of purchase. Consumption also includes foreign goods and services purchased by domestic households.

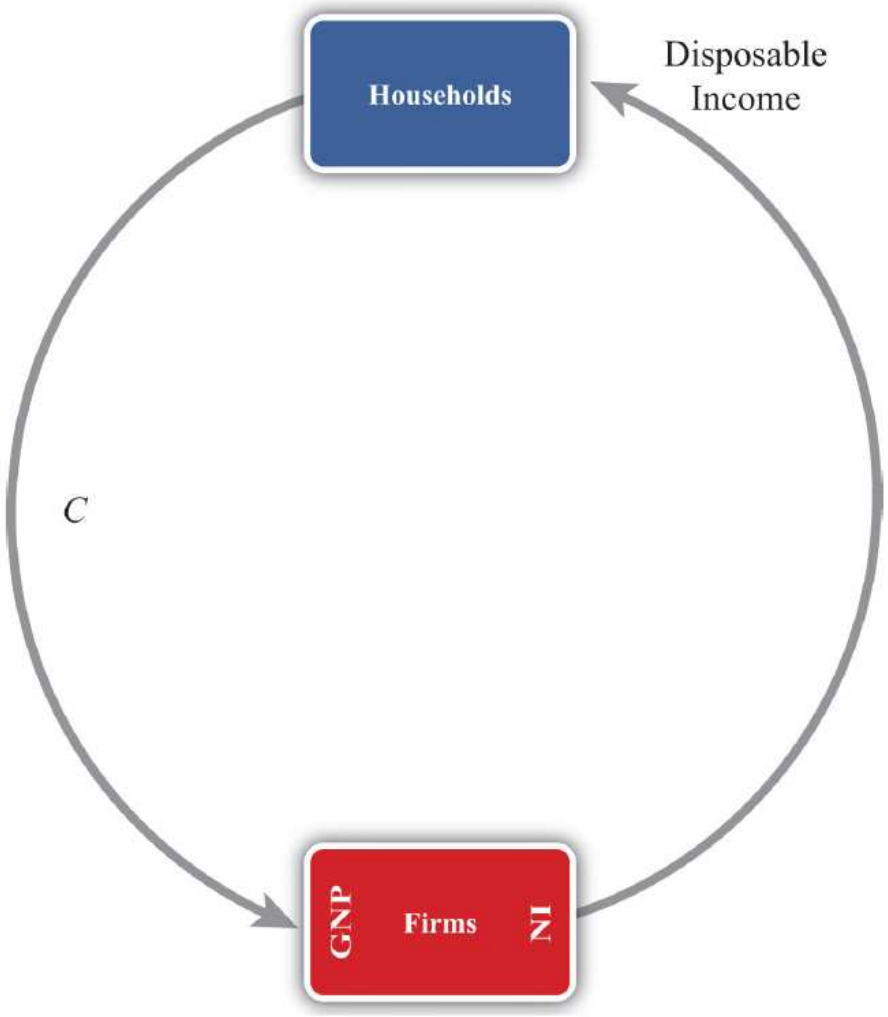
Private domestic investment (I), or "investment" for short, includes expenditures by businesses on fixed investment and any changes in business inventories. Fixed investment, both residential and nonresidential, consists of expenditures on commodities that will be used in a production process for more than one year. It covers all investment by private businesses and by nonprofit institutions, regardless of whether the investment is owned by domestic residents or not. Nonresidential investment includes new construction, business purchases of new machinery, equipment, furniture, and vehicles from other domestic firms and from the rest of the world. Residential investment consists of private structures, improvements to existing units, and mobile homes. Note that this term does not include financial investments made by individuals or businesses. For example, one purchase of stock as an "investment" is not counted here.

Government expenditures include purchases of goods, services, and structures from domestic firms and from the rest of the world by federal, state, and local government. This category includes compensation paid to government employees, tuition payments for higher education, and charges for medical care. Transfer payments, such as social insurance payments, government medical insurance payments, subsidies, and government aid are not included as a part of government expenditures.
Easy

3. Using the simplest circular flow diagram explain the flows of money within an economy.
A circular flow diagram shows the flow of money between the major players (or agents) within an economy. Circular flow diagrams can be either simple or complex depending on how many agents one introduces into the system and how finely one wishes to break down the monetary flows.

   The simplest version of a circular flow diagram considers an economy consisting of two agents: households and firms. We imagine that firms produce goods and services using labor as an input.

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The C arrow in the figure given below represents the dollar value of consumption expenditures made by households to purchase the goods and services produced and sold by firms. (The goods and services flow could be represented by an arrow in the opposite direction to C, but we leave that out for simplicity.) Since we assume in this case that there are only households buying goods, all GNP consists of C. The money that flows to firms from sales of consumption goods is given to the workers in exchange for their labor services. This monetary flow is represented by the arrow labeled "disposable income." Disposable income is all the money households have to spend, which in this case is equal to the national income (NI).
Easy

4. Discuss the various risks posed by debt and equity obligations in a nation.
Debt and equity obligations always pose several risks. The first risk with debt obligations is the risk of possible default (either total or partial). To the lender, default risk means that the IOU will not be repaid at all, that it will be repaid only in part, or that it is repaid over a much longer period of time than originally contracted. The risk of default to the borrower is that future borrowing will likely become unavailable. The advantage of default to the borrower, of course, is that not all the borrowed money is repaid.

   The second risk posed by debt is that the real value of the repayments may be different than expected. This can arise because of unexpected inflation or unexpected currency changes.

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The risk of equity purchases arises whenever the asset's rate of return is less than expected. This can happen for a number of different reasons. First, if the equity purchases are direct investment in a business, then the return on that investment will depend on how well the business performs. If the market is vibrant and management is good, then the investment will be profitable. Otherwise, the rate of return on the investment could be negative. All the risk, however, is borne by the investor. Equity purchases can suffer from exchange rate risk as well. When foreign equities are purchased, their rate of return in terms of domestic currency will depend on the currency value. If the foreign currency in which assets are denominated falls substantially in value, then the value of those assets falls along with it.
Moderate

Fill in the Blanks

1. _____ represents the total amount of money that factors of production earn during the course of a year.
   National income; Easy

2. The _____ measures the value of production in the economy and is thus a better reflector of economic well-being.
   GDP; Easy

3. _____ consists of expenditures on commodities that will be used in a production process for more than one year.
   Fixed investment; Easy

4. The U.S. economy is the largest in the world and its annual GDP in 2008 was about _____.
   $14 trillion; Easy

5. The investment expenditure component of GDP is viewed as an indicator of _____.
   future GDP growth; Easy

6. The _____ component of the current account represents the money earned by domestic residents on their investments abroad.
   income receipts; Easy

7. The current account balance is also called the _____ since it is a record of all trade in goods and services.
   trade balance; Easy

8. When a country has a current account surplus, it must have a financial account _____ of equal value.
   deficit; Easy

9. Imbalances on the balance of payment accounts arise as a result of a series of _____ transactions in which equally valued items are traded for each other.
   mutually voluntary; Easy

10. In 2008, the United States recorded a trade deficit of over _____.
    $840 billion; Easy

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11. Private saving represents a _____ of funds for the financial sector.
source; Easy

12. When domestic assets of a country exceed domestic liabilities, the country is called a _____ country.
creditor; Easy

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