Chapter 4 Quiz Answers

4. D

In the circular flow of economic activity, aggregate expenditure measures the dollar value of purchases of final goods and services.

The circular flow diagram graphically illustrates the two methods of calculating GDP. The first is to measure total expenditure. Basically, the purchase of all goods and services whether it be consumers, the government, or net exports. Net exports is the tricky one, as it can be a negative number, that is, we import more than we export, decreasing GDP.

The second way to calculate GDP is a bit harder to understand. This calculation includes all income earned by households for all of the factors of production. The easy way to realize they are the same is realizing that the costs of production plus corporate profits are included in income. Page 94 in the text explains this well. So, \( Y(\text{Income}) = C(\text{Consumption}) + I(\text{Investment}) + G(\text{Government purchases}) + (X-M)(\text{Net exports}) \)

6. A

When imports into the United States exceed exports from the United States, the United States, borrows from the rest of the world or sells foreign assets.

So, after trade we still owe the rest of the world money. We can solve this problem in one of two ways. The US could borrow from the rest of world (selling domestic assets in exchange for the currency needed), or sell foreign assets (sell bonds/financial assets already owned for the currency owed).

8. C

If the government runs a budget deficit, then part of household and business saving finances the deficit. In other words, the government is forced to borrow money.

23. D

Economists distinguish real from nominal GDP to determine whether real production has changed. If nominal GDP has risen dramatically, two things may have happened. 1. Prices simply went up. 2. Production went up.

Real GDP uses constant prices, so cause #1 is eliminated. We want to find out how production has changed, or how life has gotten better/worse, so the actual product produced is what is important, not the amount spent.

26. D

Suppose that nominal GDP per person is $21,000 in 2002, the 1998 GDP deflator is 100, and the 2002 deflator is 105. The approximate real GDP per person in 2002 is $20,000.

The problem doesn’t come out and ask for GDP in 1998 dollars, but by telling us 1998’s deflator is 100, we can tell it is the base year. All we do is $21,000/105% to obtain the answer.
27. C

Which of the following is NOT included in real GDP? – Production at home.

This is pretty easy to think through. If you mow your grass, you’ve been productive, and there is some value inherent to the act. However, it is not measurable, and you certainly wouldn’t pay yourself and then pay taxes on your income!

28. B

If a larger fraction of the adult population is working, household production not counted in real GDP decreases. Again, this is pretty intuitive. If more people are out working, they’re not home doing household production-type activities. (Vacuuming, making a birdhouse, etc…)

31. A

Because pollution reduces economic welfare, real GDP overstates economic welfare. GDP is just one component of economic welfare. Environmental quality is a factor, and if the environment is poor, you’re worse off. GDP can’t measure by how much you are worse off, so it overstates your well-being by this amount.

34. A

We should know this now after the example above. In 2002, the deflator is 105% or 1.05, so we simply divide nominal GDP (2500) by the deflator (105% or 1.05) to get $2381B

35. A

Which of the following statements about the comparison between GDP in China and in the United States is correct? China’s GDP per person is higher using purchasing power parity prices rather than the exchange rate when valuing China’s GDP in dollars. Purchasing power parity relates GDP by giving goods the same relative prices. In effect PPP takes into account that many goods and services in China have a much lower cost than in the US.