IB International Economics Higher Level (HL) Practice Exam (Sample)

Study Guide

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Questions

1. **What does price elasticity of demand measure?**
   - **A. The change in consumer income over time**
   - **B. The responsiveness of quantity demanded to price changes**
   - **C. The impact of supply changes on market dynamics**
   - **D. The proportion of income spent on a specific good**

2. **Who primarily demands a currency in a foreign exchange market?**
   - **A. Individuals looking to import goods**
   - **B. Investors seeking opportunities in foreign bonds**
   - **C. Central banks controlling currency rates**
   - **D. Industrial firms seeking raw materials**

3. **What is one advantage of a fixed exchange rate system?**
   - **A. Greater monetary policy freedom**
   - **B. Increased exchange rate risk**
   - **C. Less exchange rate uncertainty**
   - **D. Automatic adaptation to economic changes**

4. **Which graphical representation is used to illustrate absolute advantage?**
   - **A. Curved Production Possibility Curve (PPC)**
   - **B. Linear PPC with straight lines crossing**
   - **C. Three-dimensional trade graph**
   - **D. Bar chart of production outputs**

5. **What condition may lead to an appreciation of a currency's exchange rate?**
   - **A. Increased domestic inflation**
   - **B. Decreased foreign demand for exports**
   - **C. Increased foreign demand for exports**
   - **D. Increased imports**

6. In a floating exchange rate system, how is the currency valued?

A. Based on government-imposed rates

B. Based on market forces alone

C. Adjusted according to fixed rates

D. Set by international agreements

7. What does the terms of trade measure?

A. The total value of exports and imports combined

B. The ratio of average price of exports to imports

C. The balance of trade in goods and services

D. The economic influence of a country in trade

8. Why is greater price transparency beneficial in a monetary union?

A. It encourages price competition

B. It eliminates the need for imports

C. It prevents countries from trading

D. It increases the number of currencies used

9. What is the definition of demand in economics?

A. The total amount of a good available for sale

B. The willingness and ability of consumers to purchase a quantity of goods at various price levels

C. The price at which quantity demanded equals quantity supplied

D. The quantity of goods producers are willing to sell at different price levels

10. A country has an absolute advantage in producing a good when it can:

A. Produce more of it using the same resources

B. Export a greater quantity than any other country

C. Produce it at a lower cost than domestic firms

D. Import it at a reduced tariff rate

Answers

1. **B**
2. **B**
3. **C**
4. **B**
5. **C**
6. **B**
7. **B**
8. **A**
9. **B**
10. **A**

Explanations

1. What does price elasticity of demand measure?

A. The change in consumer income over time

B. The responsiveness of quantity demanded to price changes

C. The impact of supply changes on market dynamics

D. The proportion of income spent on a specific good

Price elasticity of demand specifically measures the responsiveness of the quantity demanded of a good to changes in its price. This concept quantifies how much the quantity demanded will increase or decrease when there is a change in price, providing insight into consumer behavior and how sensitive consumers are to price fluctuations. For instance, if the price of a good decreases and the quantity demanded significantly increases, the demand for that good is said to be elastic. Conversely, if a price change leads to only a small change in quantity demanded, it indicates inelastic demand. Understanding this elasticity helps businesses and policymakers make informed decisions regarding pricing strategies and tax policies, as it directly influences revenue and consumption patterns. The other choices highlight different economic concepts. The first option refers to consumer income over time, which is related to income elasticity rather than price elasticity. The third focuses on supply-side changes, which involve the responsiveness of quantity supplied and market dynamics but not directly related to demand responses. The fourth option addresses consumer spending habits, showing what portion of income goes toward particular goods, which ties into concepts of budget constraints and is not a direct measure of elasticity.

2. Who primarily demands a currency in a foreign exchange market?

A. Individuals looking to import goods

B. Investors seeking opportunities in foreign bonds

C. Central banks controlling currency rates

D. Industrial firms seeking raw materials

The primary demand for a currency in a foreign exchange market comes from investors seeking opportunities in foreign bonds. When investors are looking to invest in foreign assets like bonds, they need to purchase the local currency of the country in which the bonds are denominated. This process involves converting their own currency into the foreign currency, thereby creating demand for that currency in the foreign exchange market. This demand is often driven by factors such as higher interest rates, potential for economic growth, or favorable exchange rate movements that investors anticipate, prompting them to seek out investments in foreign markets. By purchasing foreign bonds, these investors contribute significantly to the currency's demand, as they require the necessary local currency for their investments. Individuals looking to import goods do need to exchange currency, but their demand is typically more related to specific transaction sizes rather than the broader scale of investments that a bond investor might engage in. Similarly, though central banks play a crucial role in managing currency stability and may demand foreign currency for interventions, their demand is usually more about controlling the money supply and stabilizing their own currency rather than ongoing market demand. Industrial firms seeking raw materials engage in currency exchange as well, but again, this is typically based on specific transaction needs rather than the sustained demand seen with investors in the

3. What is one advantage of a fixed exchange rate system?

A. Greater monetary policy freedom

B. Increased exchange rate risk

C. Less exchange rate uncertainty

D. Automatic adaptation to economic changes

A fixed exchange rate system provides greater stability in international trade and investment by reducing exchange rate uncertainty. This stability allows businesses to plan their transactions and investments with more confidence, as they are less likely to encounter extreme fluctuations in currency values. A predictable exchange rate enhances trade relationships and encourages foreign direct investment, as companies can forecast costs and revenues without worrying about volatility in currency values. This environment can also lead to lower costs for converting currencies, making international transactions more straightforward. When exchange rates are stable, it facilitates long-term contracts and financial agreements between entities in different countries, which further supports economic growth and cooperation. In contrast, a fixed exchange rate does not provide greater monetary policy freedom, as a country must often surrender some control over its domestic monetary policy to maintain the peg. A fixed system also does not automatically adapt to economic changes, which can lead to imbalances if the exchange rate does not reflect current economic conditions. Therefore, reduced exchange rate uncertainty is a distinct advantage of maintaining a fixed exchange rate system.

4. Which graphical representation is used to illustrate absolute advantage?

A. Curved Production Possibility Curve (PPC)

B. Linear PPC with straight lines crossing

C. Three-dimensional trade graph

D. Bar chart of production outputs

The graphical representation that is commonly used to illustrate absolute advantage is a linear Production Possibility Curve (PPC) with straight lines crossing. This type of PPC effectively helps visualize the concept of absolute advantage, which occurs when one producer can produce more of a good or service with the same amount of resources compared to another producer. In this case, if producers A and B both have linear PPCs, the straight lines indicate constant opportunity costs associated with producing the two goods. The point where their PPCs cross can denote the quantity of goods each can produce, highlighting the differences in productivity. This format allows for a clearer understanding of which country or entity holds the absolute advantage in producing certain goods based on their production capabilities. Other graphical representations, such as curved PPCs, would indicate varying opportunity costs and are more commonly used to illustrate comparative advantage rather than absolute advantage. A three-dimensional trade graph typically illustrates more complex relationships or dynamics in trade and may not convey absolute advantage as directly. A bar chart of production outputs could provide quantitative data but is less effective at illustrating the interaction and efficiency in production choices like the linear PPC does.

5. What condition may lead to an appreciation of a currency's exchange rate?

- A. Increased domestic inflation
- B. Decreased foreign demand for exports
- C. Increased foreign demand for exports
- D. Increased imports

An appreciation of a currency's exchange rate occurs when the value of that currency increases relative to other currencies. Increased foreign demand for a country's exports typically leads to this appreciation. When foreign buyers seek to purchase more goods and services from a country, they must convert their own currency into the domestic currency to make these purchases. This heightened demand for the domestic currency strengthens its value. In contrast, other options can lead to depreciation or a stagnant currency value. Increased domestic inflation tends to reduce currency value because it erodes purchasing power. Decreased foreign demand for exports directly impacts the supply and demand for the currency negatively, leading to depreciation. Lastly, increased imports can result in higher demand for foreign currencies as domestic consumers exchange their currency for foreign money to purchase goods, thereby contributing to a potential depreciation of the domestic currency. Therefore, increased foreign demand for exports is the condition that supports an appreciation of a currency's exchange rate.

6. In a floating exchange rate system, how is the currency valued?

- A. Based on government-imposed rates
- B. Based on market forces alone
- C. Adjusted according to fixed rates
- D. Set by international agreements

In a floating exchange rate system, the value of a currency is determined by market forces alone, specifically through the interactions of supply and demand in the foreign exchange market. This system allows the exchange rate to fluctuate freely based on various economic factors, including interest rates, inflation, economic stability, and overall market sentiment. The absence of government intervention or fixed rates enables the currency's value to adjust dynamically in response to economic conditions and investor behavior. This system can lead to greater volatility in exchange rates but also allows for a more accurate reflection of a country's economic situation and competitiveness on a global scale. In contrast, other choices such as government-imposed rates, fixed rates, and international agreements suggest some level of external control or predetermined valuation, which is not characteristic of a floating exchange rate system.

7. What does the terms of trade measure?

A. The total value of exports and imports combined

B. The ratio of average price of exports to imports

C. The balance of trade in goods and services

D. The economic influence of a country in trade

The terms of trade is a crucial economic concept that specifically measures the ratio of the average price of a country's exports to the average price of its imports. This ratio indicates how many units of imports can be purchased for a unit of exports. It reflects the relative cost of exporting goods compared to importing them and can provide insights into the economic health and efficiency of a nation’s trading position. When the terms of trade improve, it typically means that a country can buy more imports for the same quantity of exports, leading to an increase in national welfare. Conversely, if the terms of trade deteriorate, the purchasing power regarding imports decreases, which could negatively affect the economy. The other options do not accurately describe the terms of trade. The total value of exports and imports combined refers to trade volume rather than the price ratio. The balance of trade looks at the net exports (exports minus imports) without considering price levels. Economic influence in trade is a broader concept that might encompass aspects like political power and trade agreements, rather than just the pricing dynamics captured in the terms of trade ratio. Therefore, the choice indicating the ratio of the average price of exports to imports is the correct measurement of the terms of trade.

8. Why is greater price transparency beneficial in a monetary union?

A. It encourages price competition

B. It eliminates the need for imports

C. It prevents countries from trading

D. It increases the number of currencies used

Greater price transparency within a monetary union is beneficial primarily because it encourages price competition. In a monetary union, multiple countries share a common currency, which facilitates easier comparison of prices across borders. This transparency allows consumers to see and compare prices of similar goods and services more easily, leading to increased competition among producers and retailers. As a result, businesses are incentivized to lower their prices or improve their offerings to attract consumers, ultimately benefiting the overall economy by promoting efficiency and consumer welfare. The other options do not align with the concept of monetary unions. For example, eliminating the need for imports would contradict the principles of trade and economic interdependence fostered within a monetary union. Preventing countries from trading undermines the very purpose of a unified currency, which is to enhance trade and economic cooperation. Lastly, increasing the number of currencies used runs counter to the idea of a monetary union itself, which aims to streamline transactions and financial interactions by having a single currency. Thus, encouraging price competition is the key benefit resulting from greater price transparency in a monetary union.

9. What is the definition of demand in economics?

A. The total amount of a good available for sale

B. The willingness and ability of consumers to purchase a quantity of goods at various price levels

C. The price at which quantity demanded equals quantity supplied

D. The quantity of goods producers are willing to sell at different price levels

Demand in economics is defined as the willingness and ability of consumers to purchase a quantity of goods at various price levels. This definition captures two essential components: the desire to buy a good (willingness) and the financial capacity to do so (ability). Demand is not just a measure of how much of a good is desired but also considers whether consumers have the means to make those purchases across different price points. This relationship between price and quantity demanded forms the basis for the demand curve, which typically slopes downward, indicating that as prices decrease, the quantity demanded generally increases. The other choices focus on different aspects of economic concepts. The total amount of a good available for sale refers to supply rather than demand. The price at which quantity demanded equals quantity supplied describes market equilibrium, which is a different economic concept that addresses the interaction between supply and demand rather than demand itself. Lastly, the quantity of goods producers are willing to sell pertains to supply, highlighting producers' perspective rather than consumers' intention to purchase.

10. A country has an absolute advantage in producing a good when it can:

A. Produce more of it using the same resources

B. Export a greater quantity than any other country

C. Produce it at a lower cost than domestic firms

D. Import it at a reduced tariff rate

A country has an absolute advantage in producing a good when it can produce more of it using the same resources compared to other countries. This concept revolves around the ability of a country to utilize its resources, such as labor, capital, and land, more efficiently than others, allowing it to generate higher output for the same input levels. For example, if Country X can produce 10 tons of wheat using the same amount of land and labor that Country Y uses to produce only 5 tons, Country X has an absolute advantage in wheat production. This advantage can lead to increased efficiency and productivity, promoting specialization and trade benefits based on differing production capacities. The other options focus on aspects that do not outline absolute advantage. Exporting a greater quantity relates to trade patterns rather than raw production capabilities. Producing at a lower cost than domestic firms refers to comparative advantage rather than absolute output. Importing at a reduced tariff rate involves trade policy and does not directly address production efficiency. Thus, option A accurately captures the essence of absolute advantage in production.