Principles of Economics
Final Examination Study Guide
Mr. Baysdell

120 Questions/ 100 + 20 Extra Credit---90 Minutes—NO TIME EXTENSIONS

NOTE: This exam counts for **20 PERCENT** of your semester grade. Study hard—it will make a huge difference in your final grade.

Also keep in mind that studying old tests and study guides will help you IMMENSELY. I highly recommend glancing through every other study guide for a more in-depth discussion of some of these topics. Focus especially hard on Chapter 15-17, 4, 5, and 6.

Key Concepts: Macroeconomics

- You must understand the principles of Comparative Advantage, Absolute advantage, and be able to determine when mutually advantageous trade can occur. As long as a country gets more "stuff" in exchange than what it could produce naturally, trade is advantageous.
- Know the difference between macro- and micro- economics. Macro deals with the economy as a whole, micro looks at small parts of it (remember that studying GM is a MICRO topic).
- Consumer Price Index (CPI)-related question: You need to know that the consumer price index represents the prices in an average urban consumer's market basket.
- Understand Open Market Operations. Understand what actions the Fed can take to counteract a recession or inflation.
- From a monetary policy standpoint, the Fed can either buy back securities or adjust interest rates downward to curb inflation. It doesn't HAVE to lower interest rates. Fiscal policy to counteract a recession can include tax cuts or government spending.
- Labor productivity increases are like a "magic bullet." They increase supply and decrease inflation.
- Know the difference between substitute goods and complementary goods. Substitute goods can be used in place of one another. If substitutes exist, the demand for a product is elastic (Listerine breath strips and Wal-Mart brand breath strips). Taxes on such an item will be split by the consumers and the producers. If substitutes do not exist (insulin), taxes are passed along to consumers because demand is inelastic.
- Phillips Curve: shows an inverse relationship between inflation and unemployment. High inflation means low unemployment and vice-versa.
- Understand Stagflation.
- What types of events would reduce the United States's balance-of-trade deficit with other nations?
- Know the difference between NOMINAL and REAL GDP. If nominal GDP stays the same while Real GDP increases, then the inflation rate must be negative.
- At equilibrium, quantity demanded= quantity supplied.
- A change in the supply of oil worldwide will increase GDP and lower the price of oil. Actually, the lower oil price will stimulate greater production and larger supply, which drives down prices.

- Scenarios that would affect the international value of the United States dollar:

Higher U.S. interest rates= Higher value for the dollar (People will rush to invest money in the United States, which means they will compete to buy dollars)

Lower U.S. Government expenditures = Lower value for the dollar (Fewer dollars on the world market, demand for dollars stays the same, and the price drops)

Higher Interest Rates abroad= Lower value for the dollar (People will rush to buy other currencies so they can invest overseas; dollar is in less demand and the price will fall)

Expansionary U.S. monetary policy= Lower value for the dollar (More money in the market will drive inflation)

Reduced Inflation Abroad= Lower value for the dollar (Lower inflation overseas means that foreign currencies are worth more vis-à-vis the dollar)

- Understand how Federal Reserve requirements affect open market operations. If the Fed sells $1 million dollars worth of securities and the reserve requirement is 25%, then the Fed has actually deprived the market of FOUR million dollars worth of money. The bank gives up the ability to loan $4 Million by buying $1 Million worth of securities.
- A stimulative fiscal policy, combined with a restrictive monetary policy, will cause inflation. The government spending increases competition for money, while the money is difficult to get—result is inflation.

Key Concepts: Microeconomics

Be prepared for a possible tax return/stock sale calculation

- Understand the concept of SCARCITY. Scarcity exists if there are more uses for resources than can be satisfied at one time. Scarcity exists if decisions must be made about alternative uses for resources. Scarcity would exist in ANY society.
- Supply and Demand: Know what types of ceteris paribus conditions can cause an increase in the price of a good or service. An increase in wages decreases the supply of a good. If supply decreases and demand remains stable, prices will rise.
- Market Clearing Prices: Know that an increase in income will cause demand to increase for normal goods. Prices will rise as consumers compete. This is also known as the wealth effect.
- Competition: Be able to distinguish between monopoly, oligopoly, perfect competition, and monopolistic competition**. A market can't be perfectly competitive if price exceeds marginal cost.**
- Elasticity: Understand the principle of UNIT PRICE ELASTICITY. This simply means that you will spend the same AMOUNT OF MONEY on a product when its price changes.
- At the Margin: As a firm's output increases, the short-run marginal cost will eventually increase because of diminishing marginal returns. In other words, the cost of producing one more good can become prohibitive. Think of the situation where producing 1 more car would require you to hire a whole overtime shift of people—with huge costs as a result.
- When average variable costs are increasing, marginal variable costs must be increasing higher than the average marginal variable cost.
- If the marginal cost curve of a monopolist shifts upwards, the price of the good will increase and the supply will decrease. Higher costs mean that you can't produce as many goods with the capital that you possess. Fewer goods on the market coupled with demand that doesn't change means that the price of goods go up.

- When government steps in and makes a company absorb its own spillover costs, the price of the goods and services produced by that company goes up, and output decreases.
- If a good is elastic, then producers and consumers share the tax burden or incidence. If a good is inelastic, consumers bear the burden alone. (EX: Insulin tax hike would be paid by consumers)
- In a graph demonstrating supply and demand, you can calculate tax collected by the government by multiplying the Tax Rate by the quantity of product sold. EX: If the whiskey tax is $6 a gallon, and 100 million gallons are sold, the government collects $600 Million in taxes.
- Taxes cause the supply curve to shift up and to the left.
- An economy can increase both defense and domestic spending only if some resources were not being fully employed and were put to work. The Production Possibilities Curve will shift to the right, and you can have more "guns" and more "butter."
- If a perfectly competitive industry is in long-run equilibrium, firms must be earning an investment on their returns that is equal to their opportunity costs. If firms were earning less, some would leave. If firms were earning more, more firms would enter the market.
- Monopolists produce too little of a good and charge an inflated price.

ALL TOPICS/MIX OF MACRO AND MICRO:

- Capital is any resource made by humans used to create other goods and services.
- Remember the different types of statements and fallacies. Know the difference between POSITIVE and NORMATIVE economics statements. Positive economic statements don't state opinions—they just give facts. Normative statements states opinions as to what will happen when certain economic policies are employed.
- Know the various fallacies of economics:
- Causation does not imply correlation!
- Post hoc, ergo propter hoc: After this, therefore because of this
- Fallacy of Composition: Can't always generalize specific cases
- A production possibilities graph shows alternative ways to use an economic resource. Production possibilities frontiers show the maximum amount that an economy can produce. Production possibilities frontiers curve when they are charted on a graph because they show the increasing costs resulting in increasingly less output. It gets much more difficult to shift resources as you demand more of one product and less of another. In the beginning, people can easily shift over (some might have worked in the factory before or have experience). Later, however, you begin to recruit new workers as you expand production further, and you must train these people, some of whom are not as efficient a worker as the first group you hired.
- All goods and services are scarce because all resources are scarce.
- An example of physical capital is a factory building.
- An example of an efficient economy is one that uses its resources to make the greatest possible number of goods and services.
- Know what a key economic question would be. Example: Who consumes these goods and services?
- The process of specialization makes the economy more efficient. Nations can have an absolute advantage in producing a good, which means that they can produce all goods with less labor than another country, or a comparative advantage, which means that they can produce one good much more efficiently than another—which allows the other country to specialize in making one product even though they might be less efficient in producing that product.

- A product market is the market in which households purchase the goods and services that firms produce. A factor market is where the 4 factors of production (land, labor, capital, and management) are sold.
- Making a profit on sales is an incentive for manufacturers to sell their products.
- The market in Canada would likely be characterized as mixed, but on the side of free market.
- A free rider is someone who consumes a good (usually a public good), but does not directly pay for it. EX: A traveler from another state drives on a Michigan state highway
- Most-Favored Nation (MFN) status DOES NOT mean a country gets "preferential" trade stats. MFN means NORMAL TRADE RELATIONS. For a long time, we kept China on a yearly-MFN or not basis. Now they are considered MFN. An MFN nation pays the same tariffs as those paid by other MFN countries.
- The largest trading partner of the United States is the European Union. The largest single country trade partner of the United States is Canada.
- Know the types of financial intermediaries and the services they provide (ex: banks, credit unions). Stocks are NOT offered by financial intermediaries.
- Bonds are NOT insured by the FDIC. The FDIC only insures deposits up to $100,000.
- Understand the arguments of both Supply-side economists and Keynesian Economists.
- Know the advantages of money (portability, durability, uniformity, divisibility, etc). and what each of these terms means.
- GDP only counts FINISHED goods. Intermediate goods are not counted in GDP to avoid the DOUBLE COUNTING PROBLEM, which would result in overestimates of GDP.
- Operating budgets are for day-to-day expenses, capital budgets are for investment purposes.
- The two most effective ways for consumers to make their wishes known to business and government is by purchasing products and voting.
- Governments require businesses to disclose information because it makes buyers more knowledgeable, safer, and allows them to make better, informed decisions.
- Seasonal unemployment occurs because some industries have peak times (retailers will often hire people over the holiday season and then let them go afterwards); structural unemployment occurs because employees lack skills.
- When unemployment is low, companies have difficulty recruiting workers and may have to raise wages to compete for workers.
- A means-tested program uses income level as an eligibility test. (EX: TANF)
- Withholding works well for governments because they don't have to wait to get all their money on tax day—they can pay bills as they come due.
- Know what an externality is. They can be positive or negative. Positive externalities generate unexpected benefits; negative externalities generate unexpected costs. Orchard owners consider bee roaming around from beekeepers as a positive externality because the bees pollinate plants; a chemical factory dumping waste into a river is a negative externality—a spillover cost that is not absorbed and which allows that company to make more money than they otherwise would if they had to pay for cleaning up the waste.
- Money market funds are NOT insured by the FDIC, but they are a low-risk investment. Most bonds are low-risk investments, but jnk bonds are a high risk investment.
- A stock split usually occurs when a company's stock price has been rising and the company wants to make the stock more attractive to a wider range of investors.
- Total revenue of a company= total receipts of sales
- The Law of Supply states that when prices increase, supply will increase, and vice-versa.
- Price ceilings are usually placed on goods that are expensive but necessary for consumers to have (EX: Rent control). Price ceilings create shortages if the imposed price is less than the equilibrium price. Both price ceilings and price floors result in a reduction of goods bought and sold.
- Under black market conditions, product quality becomes less certain, price is higher compared to legal markets, and the threat of violence to resolve economic disputes increases.

- With respect to markets for prohibited goods: Penalizing sellers decreases supply, penalizing buyers decreases demand. This reduces the quantity purchased. Taxes achieve much the same effect (cigarettes are now almost "de facto" prohibited).
- KNOW THE DIFFERENCE BETWEEN ELASTIC GOODS AND INELASTIC GOODS. Insulin is inelastic—you have to have it if you're a diabetic, regardless of price. Pringles are elastic—if the price gets too high, you'll just snack on something else.
- If future prices are expected to rise, people will demand more of a good.
- The business cycle has fewer up-and-down cycles than the day-to-day ups and downs of the market.
- When commodities are owned communally, there is little incentive for conservation (remember Save the Whales activity)
- The main goal of a firm is to make as much profit as possible.
- Public goods are non-excludable; it is difficult to stop people who don't want to pay for a good from enjoying it after the fact.
- New technology can lead to increased productivity, which increases supply and lowers prices for all.
- A fringe benefit is a payment other than wages or salaries (EX: Health care benefits). Employers like to provide these rather than wages because neither employees nor employers pay tax on these.

Terminology:

Not all of these are on the test, but it suffices to say that if you know all of these, you're not going to miss any on the matching portion!

a. factors of production
b. production possibilities frontier
c. production possibilities graph
d. trade-offs
e. shortage
f. scarcity
g. growth
h. opportunity cost
i. underutilization
j. efficiency
k. services

a. free enterprise
b. continuum
c. incentive
d. safety net
e. collective
f. socialism
g. transition
h. traditional economy
i. authoritarian
j. standard of living

a. gross domestic product
b. free rider
c. public interest
d. private sector
e. in-kind benefits
f. macroeconomics
g. poverty threshold
h. market failure
i. welfare
j. public disclosure laws

a. subsidy
b. supply schedule
h. increasing marginal returns
i. diminishing marginal returns

c. supply curve
d. elasticity of supply
e. excise tax
f. law of supply
g. variable cost
j. marginal revenue
k. marginal product of labor
l. marginal cost
m. market supply schedule

a. increasing marginal returns
b. diminishing marginal returns
c. marginal revenue
d. marginal product of labor
e. marginal cost
f. supply schedule
g. quantity supplied
h. market supply curve
i. total cost
j. law of supply
k. variable
l. elasticity of supply
m. regulation

a. blue-collar worker
b. white-collar worker
c. closed shop
d. strike
e. screening effect
f. agency shop
g. skilled labor
h. featherbedding
i. arbitration
j. contingent employment

a. bear market
b. bull market
c. capital gain
d. equities
e. financial asset
f. investment
g. par value
h. portfolio
i. prospectus
j. yield

a. aggregate supply
b. aggregate demand
c. depreciation
d. gross domestic product
e. gross national product
f. national income accounting
g. recession
h. stagflation
i. technological progress
j. trough

a. aggregate supply
b. aggregate demand
c. contraction
d. depreciation
e. gross domestic product
f. gross national product
g. leading indicators
h. national income accounting
i. stagflation
j. technological progress

a. chronic inflation
b. deflation
c. frictional employment
d. wage-price spiral
e. poverty threshold
f. block grant
g. quantity theory
h. creeping inflation
i. purchasing power
j. market basket

a. corporate income tax
b. estate tax
c. regressive tax
d. proportional tax
e. individual income tax
f. gift tax
g. incidence of a tax
h. deductions
i. real property
j. Medicaid
k. withholding
l. Social Security

a. individual income tax	g. balanced budget
b. tax return	h. discretionary spending
c. tax incentive	i. mandatory spending
d. tax exempt	j. Medicare
e. tax assessor	k. tariff
f. tax base	l. personal property

a. appropriations bill	f. national debt
b. crowding-out-effect	g. productive capacity
c. federal budget	h. Treasury bill
d. fiscal policy	i. Treasury bond
e. multiplier effect	j. Treasury note

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a. prime rate	f. easy money policy
b. required reserve ratio	g. tight money policy
c. check clearing	h. federal funds rate
d. open market operations	i. Board of Governors
e. net worth	j. Federal Reserve Districts

a. discount rate	f.	Federal Advisory Council (FAC)
b. money multiplier formula	g.	monetary policy
c. money creation	h.	monetarism
d. inside lag	i.	bank holding company
e. outside lag	j.	open market operations

a. World Trade Organization (WTO)	f. import quota

b. NAFTA
c. European Union (EU)
d. appreciation
e. trade war
g. comparative advantage
h. absolute advantage
i. protectionism
j. export

. arable
b. development
c. foreign direct investment (FDI)
d. foreign portfolio investment
e. *glasnost*
f. infrastructure
g. International Monetary Fund (IMF)
h. *perestroika*
i. privatization
j. World Bank