

# **International Business and Finance**

## **Week 3 Seminar 3**

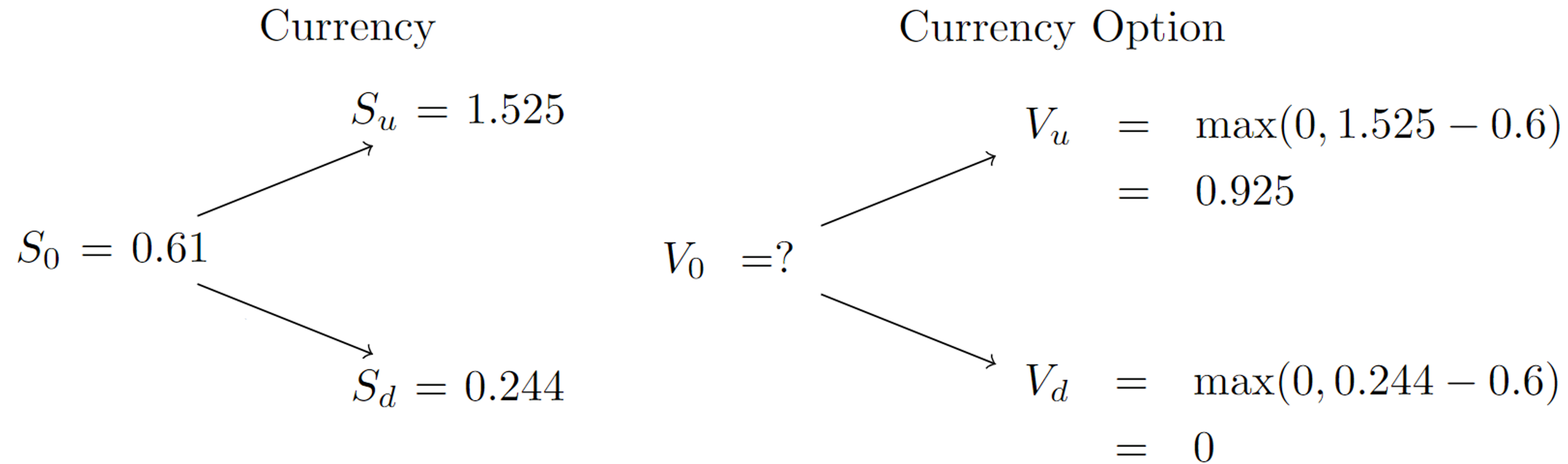
Dr. Cholwoo Kim

# Exercise: Currency Option

The Australian dollar is currently worth 0.61 US dollars (i.e. USD/AUD = 0.61). The **risk-free interest rate** is **7% in Australia** and **5% in the U.S.** In one year, the Australian dollar will either **appreciate by 150%** or **depreciate by 60%**. What is the value of the one-year call option with a strike of **0.60 USD/AUD**? (Use the risk neutral probability approach.)

- ▶ The problem situation can be summarised as follows:
  - ▶ **Local currency (LC) = USD / Foreign currency (FC) = AUD**
  - ▶ The strike price:  $K = 0.60$  USD/AUD
  - ▶ Spot exchange rate:  $S_0 = 0.61$  USD/AUD
  - ▶ Local (USD) risk-free rate:  $r_{LC} = 5\%$
  - ▶ Foreign (AUD) risk-free rate:  $r_{FC} = 7\%$
  - ▶ In one year, AUD will
    - Appreciate by 150%  $\rightarrow S_u = 0.61 \times (1 + 1.5) = 1.525$  USD/AUD: up factor  $u = 2.5$
    - Depreciate by 60%  $\rightarrow S_d = 0.61 \times (1 - 0.6) = 0.244$  USD/AUD: down factor  $d = 0.4$

# Exercise: Currency Option



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# Exercise: Currency Option

With no arbitrage condition, we have the following equality:

$$1 + r_{LC} = (1 + r_{FC}) \frac{[pS_u + (1 - p) S_d]}{S_0}$$

- LHS: Expected return on the domestic investment
- RHS: Expected return on the foreign investment expressed in domestic currency

Rearranging the equation, we have (1).

$$\frac{S_0}{1 + r_{FC}} = \frac{pS_u + (1 - p) S_d}{1 + r_{LC}} = \frac{puS_0 + (1 - p) dS_0}{1 + r_{LC}} \quad (1)$$

From this equation, we can find the probabilities:

$$p = \frac{\left(\frac{1+r_{LC}}{1+r_{FC}}\right) - d}{u - d} = \frac{\left(\frac{1+0.05}{1+0.07}\right) - 0.4}{2.5 - 0.4} = 0.2768$$

Thus, the value of the call option is:

$$V_0 = \frac{pV_u + (1 - p) V_d}{1 + r_{LC}} = \frac{0.2768 \times 0.925 + (1 - 0.2768) \times 0}{1.05} = 0.244$$

# Gross Domestic Product

- ▶ Gross domestic product (GDP) is the **market value of all final goods and services** produced within a country **in a given period of time**.

- ▶ Closed economy

$$Y = C + I + G$$

- ▶ C: Consumption (the amount consumed by private domestic residents)
- ▶ I: Investment (the amount put aside by firms to build new plants and equipment)
- ▶ G: Government purchases (the amount used by the government)

- ▶ Open economy

$$Y = C + I + G + X - M$$

- ▶ X: value of goods and services exported (sold to the rest of the world)
- ▶ M: is the value of goods and services imported (purchased from the rest of the world)

## Trade Balance

- ▶ Countries trade a lot with one another, and the UK is no exception. In this respect, we need to understand international transactions involved in trade.
- ▶ In the UK international transactions are recorded by the Office of National Statistics (ONS) in the "Balance of Payments (BoP)" accounts.
- ▶ An important figure produced in the "Balance of Payments" is the **Trade Balance**:

$$\text{Trade Balance} = \text{Goods Balance} + \text{Service Balance}$$

$$\text{Goods(Service) Balance} = \text{Exports of Goods(Services)} - \text{Imports of Goods(Services)}$$

- ▶ Examples of goods: computers, cars, gas, rice, ...
- ▶ Examples of services: education, consulting, medical care, ...

## Income Balance

- ▶ Another component of the Current Account is the **Income Balance**, which measures the difference between factor incomes received from the rest of the world and factor incomes paid to the rest of the world.
- ▶ **Net Investment Income:** Net cross-border earnings from providing capital, e.g.) dividends, interest, ...
- ▶ **Net International Payments to Employees:** Net cross-border earnings from labour, e.g.) earnings of UK residents employed abroad, ...

$$\text{Income Balance} = \text{Net Investment Income} + \text{Net International Payments to Employees}$$

## Net Unilateral Transfers

- ▶ The third component in the Balance of Payments is **Net Unilateral Transfers**, which keeps record of the difference between **gifts received** from the rest of the world and **gifts given** to the rest of the world. These gifts can involve private agents or governments.
- ▶ This includes:
  - ▶ **Private Remittances**: money sent by individuals abroad to family members.
  - ▶ **Government Transfers**: foreign aid, disaster relief, etc.

$$\text{Net Unilateral Transfers} = \text{Private Remittances} + \text{Government Transfers}$$

## Current Account

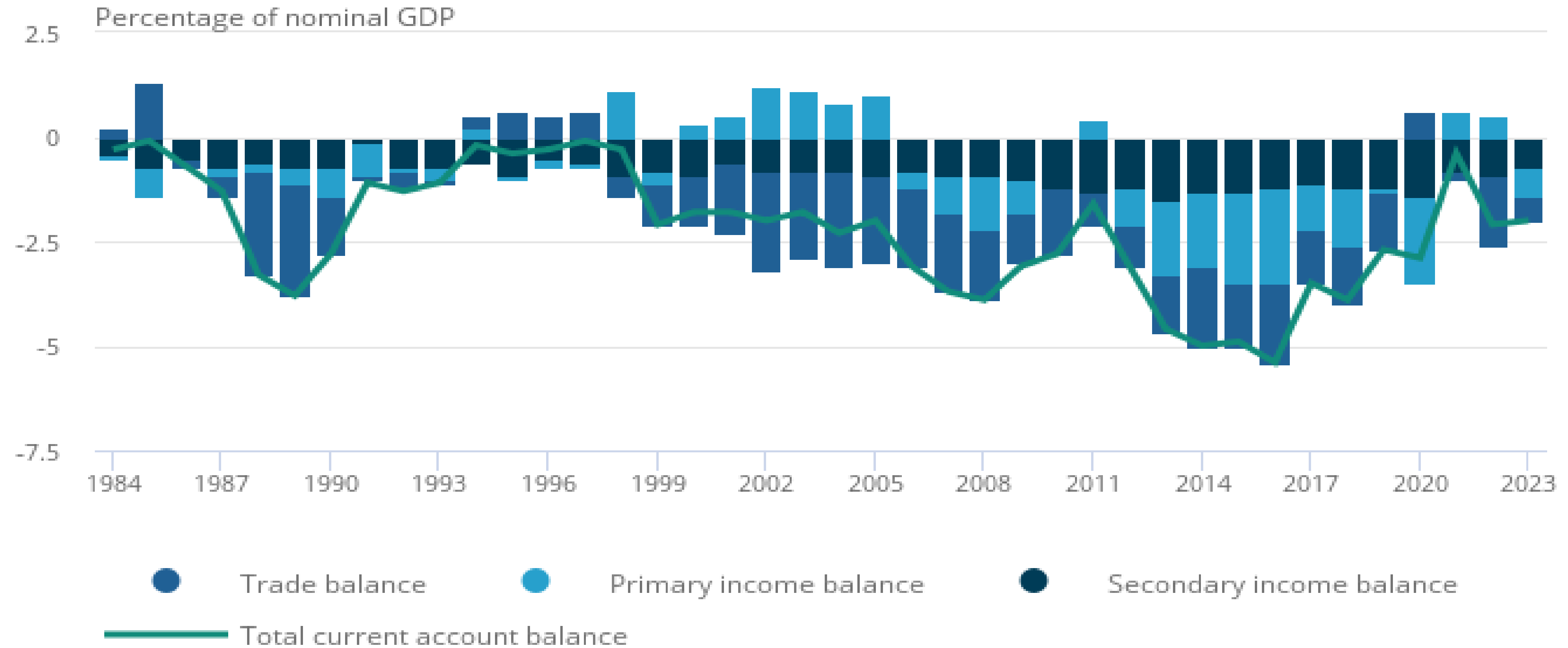
- ▶ The Current Account is the sum of the Trade Balance, the Income Balance, and Net Unilateral Transfers:

$$\text{Current Account} = \text{Trade Balance} + \text{Income Balance} + \text{Net Unilateral Transfers}$$

- ▶ The current account is an important concept because if the current account is **negative**, all other things equal, the **net external debt of the country goes up**, and if the current account is **positive**, the **external debt falls**.

# International Transactions

## UK current account balance as a percentage of nominal GDP, 1984 to 2023



Source: [Balance of payments from the Office for National Statistics](#)

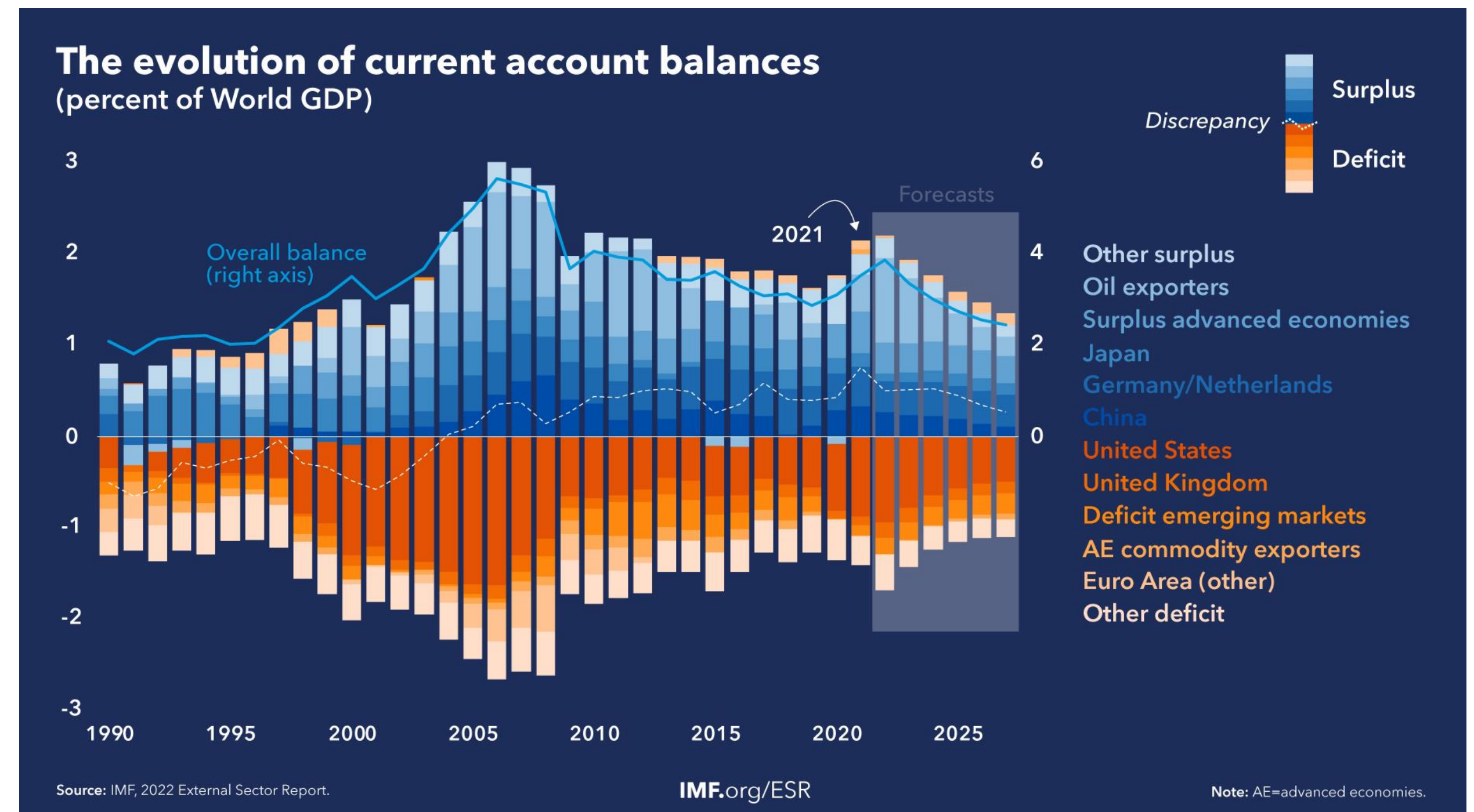
## Global Imbalances

- ▶ If the UK is running a large current account deficit, some other countries must be running current account surpluses. Why?

$$CA^{UK} + CA^{ROW} = 0$$

where ROW denotes the rest of the world.

- ▶ **Global Imbalances:** The graph reflects a pattern of imbalanced trade, with some countries (Japan, Germany, China) running persistent current account surpluses, while others (US, UK) maintain prolonged deficits.
- ▶ Persistent imbalances can be a signal of systemic risk.



# Questions

**Q1.** Which of the following transactions will be included in the GDP for the United States? Explain why?

- a) Coca Cola builds a new bottling plant in the United States.
- b) Northwest Airlines sells one of its existing airplanes to Korean Air.
- c) Ms. Moneybags buys an existing share of Disney stock.
- d) A California winery produces a bottle of Chardonnay and sells it to a customer in Montreal.
- e) A book publisher produces too many copies of a new book. The books do not sell this year, so the publisher adds the surplus to inventories.

**Q2.** In 2024, **Outland** begins the year holding **100 shares** of the German car company Volkswagen. These shares are denominated in euros. At the same time, the rest of the world holds **200 units of dollar-denominated bonds** issued by the Outlandian government. At the beginning of the year, the price of each Volkswagen share is **1 euro**, the price of each Outlandian bond is **2 dollars**, and the exchange rate is **1.5 dollars per euro**.

During the year, Outland exports toys worth 7 dollars and imports shirts worth 9 euros. The rate of return on the Volkswagen shares is **5 percent**, while the rate of return on the Outlandian bonds is **1 percent**. Outland residents **receive 3 euros** from relatives living abroad, and the Outlandian government **donates 4 dollars** to a hospital in Guyana.

Based on this information, calculate Outland's **trade balance**, **income balance**, and **net unilateral transfers** for 2024. Then, determine its **current account balance** for the year.

**Q3.** Explain how each of the following transactions impacts the U.S. current account.

- a) An American university buys several park benches from Spain and pays with a \$120,000 check.
- b) Floyd Townsend, of Tampa Florida, buys 5,000.00 dollars worth of British Airlines stock from Citibank New York, paying with U.S. dollars.
- c) A group of American friends travels to Costa Rica and rents a vacation home for \$2,500. They pay with a U.S. credit card.
- d) The United States sends medicine, blankets, tents, and nonperishable food worth 400 million dollars to victims of an earthquake in a foreign country.

# Questions

**Q1.** Which of the following transactions will be included in the GDP for the United States? Explain why?

▶ **Remember**

Gross domestic product (GDP) is the market value of all final goods and services produced within a country in a given period of time.

- a) Coca Cola builds a new bottling plant in the United States.
- b) Northwest Airlines sells one of its existing airplanes to Korean Air.
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# Questions

a) Coca Cola builds a new bottling plant in the United States.

▶ **YES:**

It is an investment spending and included in GDP



**Remember:**

$$Y = C + I + G + NX$$

- Coca Cola Investment

# Questions

b) Northwest Airlines sells one of its existing airplanes to Korean Air.

▶ **NO:**

It does not represent production in the current time period. The plane was already included in the production year, so sale of used item is not part of GDP.



## Remember:

Gross domestic product (GDP) is the market value of all final goods and services produced within a country **in a given period of time**

- GDP is a flow



# Questions

c) Ms. Moneybags buys an existing share of Disney stock.

► **NO:**

When an individual buys an existing share of stock the transaction is a financial one, therefore it is not included in the GDP.



## Remember:

Gross domestic product (GDP) is the market value of all final goods and services produced within a country in a given period of time

- Financial transactions do not involve production

# Questions

d) A California winery produces a bottle of Chardonnay and sells it to a customer in Montreal.

► **YES:**

It is an export and is entered in US GDP.



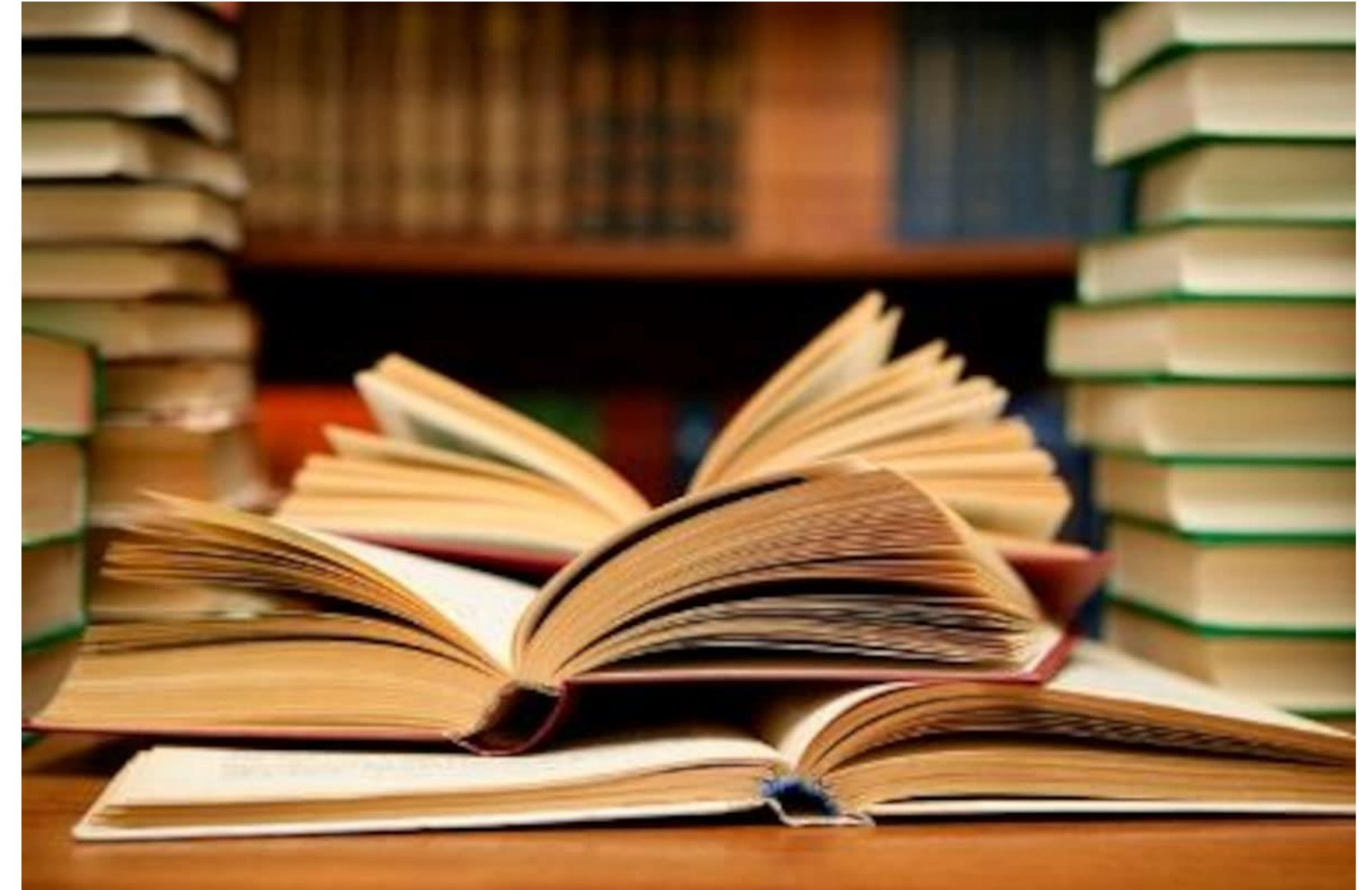
## Remember:

$$Y = C + I + G + NX$$

- From California(US) to Montreal(Canada)

# Questions

e) A book publisher produces too many copies of a new book. The books do not sell this year, so the publisher adds the surplus to inventories.



► **YES:**

These books are considered **investment spending** and added to GDP. It is as if the publisher bought the books itself. In other words, inventories are part of the investment.

# Questions

**Q2.** In 2024, **Outland** begins the year holding **100 shares** of the German car company Volkswagen. These shares are denominated in euros. At the same time, the rest of the world holds **200 units of dollar-denominated bonds** issued by the Outlandian government. At the beginning of the year, the price of each Volkswagen share is **1 euro**, the price of each Outlandian bond is **2 dollars**, and the exchange rate is **1.5 dollars per euro**.

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Based on this information, calculate Outland's **trade balance**, **income balance**, and **net unilateral transfers** for 2024. Then, determine its **current account balance** for the year.

# Questions

The problem situation can be summarised as follows:

- ▶ Outland has 100 VW Shares in € and each is €1
- ▶ RoW has 200 units Outlandian Bonds in \$ and each is \$2
- ▶ FX rate:  $S = 1.5 \text{ \$/€}$
- ▶ Exports toys → \$7 // Imports shirts → €9
- ▶ The rate of return on VW → 5% // The rate of return on Outlandian Bonds → 1%
- ▶ Money received → €3 // Gift given → \$4

▶ The Trade Balance is:

$$\begin{aligned} \text{TB} &= \$7 - €9 \times 1.5 \text{ \$/€} \\ &= -\$6.5 \end{aligned}$$

# Questions

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  - ▶ Money received → €3 // Gift given → \$4
- ▶ Since there is no employee compensation, the Income Balance equals net investment income:

$$\begin{aligned} \text{IB} &= 0.05 \times (100 \times \text{€}1 \times 1.5 \text{ \$/€}) - 0.01 \times (200 \times \$2) \\ &= \$3.5 \end{aligned}$$

# Questions

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- ▶ Net Unilateral Transfers amount to:

$$\begin{aligned} \text{NUT} &= \text{€}3 \times 1.5 \text{ \$/€} - \$4 \\ &= \$0.5 \end{aligned}$$

# Questions

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- ▶ The Current Account is the sum of these three components:

$$\begin{aligned} CA &= TB + IB + NUT \\ &= - \$6.5 + \$3.5 + \$0.5 \\ &= - \$2.5 \end{aligned}$$

# Questions

**Q3.** Explain how each of the following transactions impacts the U.S. current account.

▶ **Remember**

The Current Account (CA) is the sum of the Trade Balance (TB), the Income Balance (IB), and Net Unilateral Transfers (NUT):

$$CA = TB + IB + NUT$$

- a) An American university buys several park benches from Spain and pays with a \$120,000 check.
- b) Floyd Townsend, of Tampa Florida, buys 5,000.00 dollars worth of British Airlines stock from Citibank New York, paying with U.S. dollars.
- c) A group of American friends travels to Costa Rica and rents a vacation home for \$2,500. They pay with a U.S. credit card.
- d) The United States sends medicine, blankets, tents, and nonperishable food worth 400 million dollars to victims of an earthquake in a foreign country.

# Questions

- a) An American university buys several park benches from Spain and pays with a \$120,000 check.
- ▶ The import of merchandise from Spain deteriorates the U.S. trade balance (-\$120,000). Thus, in turn, the current account surplus decreases.

# Questions

b) Floyd Townsend, of Tampa Florida, buys 5,000.00 dollars worth of British Airlines stock from Citibank New York, paying with U.S. dollars.

- ▶ Since this transaction takes place between two American companies, it causes no change in the overall level of the U.S. current account.

# Questions

- c) A group of American friends travels to Costa Rica and rents a vacation home for \$2,500. They pay with a U.S. credit card.
- ▶ Renting a vacation home abroad amounts to importing a service, so it deteriorates the U.S. trade balance and the current account by \$2,500.

# Questions

d) The United States sends medicine, blankets, tents, and nonperishable food worth 400 million dollars to victims of an earthquake in a foreign country.

- ▶ Foreign aid gives rise to two offsetting entries in the current account: an export of goods (which improves the U.S. merchandise trade balance) and a unilateral transfer to waive the corresponding payment (which deteriorates the U.S. net unilateral transfers account). As the value of the merchandise is 400 million dollars, the U.S. current account looks as follows:

$$CA = TB + IB + NUT = 400M + 0 + (-400M) = 0$$

# Practise Questions

# Quiz questions

**1) Which of the following terms refers to the broadest measure of economic development of a country?**

- A) gross domestic product (GDP)
- B) purchasing power parity (PPP)
- C) gross national product (GNP)
- D) human development index (HDI)

Answer: C

**2) The measure of the value of production that occurs within a country's borders without regard to whether the production is done by domestic or foreign factors of production is its \_\_\_\_\_.**

- A) net national product (NNP)
- B) gross national product (GNP)
- C) gross domestic product (GDP)
- D) gross national income (GNI)

Answer: C

**3) The \_\_\_\_\_ of a country is its gross national product divided by its population.**

- A) GNP per capita
- B) GDP per capita
- C) purchasing power parity
- D) purchasing power

Answer: A

# Quiz questions

**4) The relative ability of two countries' currencies to buy the same basket of goods in those two countries is called \_\_\_\_\_.**

- A) gross national product
- B) gross domestic product
- C) purchasing power
- D) purchasing power parity

Answer: D

**5) \_\_\_\_\_ is the value of goods and services that can be purchased with one unit of a country's currency.**

- A) Potential output
- B) Gross national product
- C) Purchasing power
- D) Gross domestic product

Answer: C

**6) Gross national income (GNI), the broadest measure of economic activity for a country, is defined as the \_\_\_\_\_.**

- A) total of all consumption and investment that takes place in a national economy
- B) income generated in one country, regardless of who owns the productive assets
- C) total of all economic activity in one country less services, such as government administration, health services, and education
- D) income generated by both total domestic production and the international production activities of national companies

Answer: D

# Quiz questions

**7) Which of the following terms is used to refer to the exchange of goods and services for other goods and services instead of money?**

- A) fiat money
- B) letter of credit
- C) barter
- D) guanxi

Answer:

**8) The GDP per capita of a country is lower than that of France. If the GDP per capita of the country is adjusted for PPP, the country's revised GDP is higher than that of France. Which of the following is most likely true about the country?**

- A) The cost of living in the country is higher than that of France.
- B) The cost of living in the country is lower than that of France.
- C) The cost of living in the country is approximately equal to that of France.
- D) The cost of living in the country has increased over the past decade.

Answer: B

**9) The GDP per capita of a country is higher than that of Thailand. If the GDP per capita of the country is adjusted for PPP, the country's revised GDP is lower than that of Thailand. Which of the following is most likely true about the country?**

- A) There are fewer goods available for purchase in the country than in Thailand.
- B) The cost to buy everyday goods in the country is approximately the same as in Thailand.
- C) It costs less to buy everyday goods in the country than in Thailand.
- D) It costs more to buy everyday goods in the country than in Thailand.

Answer: D

# Quiz questions

**10) Which of the following measures the extent to which a government equitably provides its people with a long and healthy life, an education, and a decent standard of living?**

- A) category development index
- B) gross national product index
- C) human development index
- D) purchasing power index

Answer: C

**11) A company is conducting research on new markets by comparing countries in terms of their human development index (HDI) scores. The company wishes to expand into a market where individuals experience a very high level of total well-being. Which of the following countries would the company most likely choose?**

- A) Russia
- B) Mexico
- C) China
- D) Japan

Answer: D

**12) Which of the following is true about the economic development of a nation?**

- A) The purchasing power parity is a poor indicator of a people's total well-being.
- B) GDP is a larger figure and includes a nation's income generated from exports, imports, and international operations.
- C) Illegal activities such as gambling and black market transactions are considered in GDP and GNP.
- D) Using gross product figures to compare production across countries accounts for different cost of living in each country.

Answer: A

# Quiz questions

**13) Which of the following statements is true of national production?**

- A) Marketers use GDP or GNP figures to determine whether a country's population is wealthy enough to purchase its products.
- B) Per capita numbers provide a detailed picture of the development of the entire country.
- C) Gross product figures accurately indicate whether a nation's economy is growing or shrinking.
- D) Volunteer work and unpaid household work are considered in GDP and GNP.

Answer: A

**14) Nations having the poorest infrastructures and lowest personal incomes are called \_\_\_\_\_.**

- A) developed countries
- B) newly industrialized countries
- C) emerging markets
- D) developing countries

Answer: D

**15) A country that has recently increased the portion of its national production and exports derived from industrial operations is called a(n) \_\_\_\_\_.**

- A) newly industrialized country (NIC)
- B) developing country
- C) emerging market
- D) developed country

Answer: A

# Quiz questions

**16) Both GDP and GNP measure a nation's income per person.**

Answer: FALSE

**17) Volunteer work and unpaid household work are not included in GNP.**

Answer: TRUE

**18) Barter is an alternative for buyers who lack the money needed to pay for exports.**

Answer: FALSE

**19) The concept of purchasing power parity (PPP) must be applied to understand the true value of a currency in its home country.**

Answer: FALSE

**20) The human development index (HDI) demonstrates that high national income alone guarantees human progress.**

Answer: FALSE

**21) Nations with the poorest infrastructures and lowest personal incomes are called developing countries.**

Answer: TRUE

**22) One of the key obstacles faced by countries in economic transition is the lack of managerial expertise.**

Answer: TRUE

# Quiz questions

## **23) How does economic development in countries affect international business?**

Answer: Economic development is an increasingly important topic for international business people as companies pursue business opportunities in emerging markets. Productivity is a key factor that drives economic growth and rising living standards. For a company to boost its productivity, it must increase the value of its outputs using the same amount of inputs, create the same value of outputs with fewer inputs, or do both at the same time.

Raising living standards in an economy depends in large part on unlocking the gains that productivity offers. Mixed economies in Western Europe continue to privatize state-owned companies to boost productivity and competitiveness. Former centrally planned economies in Eastern Europe implemented free-market reforms to raise living standards. Even North Korea (with one of the lowest standards of living outside Africa) is being compelled to consider economic reform.

As the poorest nations invest in the fundamental drivers of productivity growth (such as basic infrastructure), the richest nations exploit the latest technological advancements.

Information technology is driving productivity gains in online customer service, online purchasing of materials and parts, outsourcing operations, and other areas of business.

## **24) Differentiate between GDP and GNP. Briefly discuss the drawbacks of using GDP and GNP as indicators of economic development.**

Answer: Gross national product (GNP) is the value of all goods and services produced by a country's domestic and international activities over a one-year period. Gross domestic product (GDP) is the value of all goods and services produced by a domestic economy over a one-year period. GDP is a narrower figure that excludes a nation's income generated from exports, imports, and the international operations of its companies.

Although GDP and GNP are the most popular indicators of economic development, they have several important drawbacks. First, for a variety of reasons, many of a nation's transactions do not get counted in either GDP or GNP. Second, gross product figures do not indicate whether a nation's economy is growing or shrinking—they are simply a snapshot of one year's economic output. Third, per capita numbers provide an average figure for an entire country, which does not give us a very detailed picture of development. Finally, country comparisons using gross product figures can be misleading.

# Quiz questions

**25) How are countries classified? Explain with examples.**

Answer: Nations are commonly classified as being developed, newly industrialized, or developing.

Countries that are highly industrialized and highly efficient, and whose people enjoy a high quality of life are developed countries. People in developed countries usually receive the finest health care and benefit from the best educational systems in the world. Countries in this category include Australia, Canada, Japan, New Zealand, and the United States.

Countries that recently increased the portion of their national production and exports derived from industrial operations are newly industrialized countries (NICs). The NICs are located primarily in Asia and Latin America. Most listings of NICs include Asia's "four tigers" (Hong Kong, South Korea, Singapore, and Taiwan), Brazil, China, India, Malaysia, Mexico, South Africa, and Thailand.

Nations with the poorest infrastructures and lowest personal incomes are called developing countries (also called less-developed countries). These countries often rely heavily on one or a few sectors of production, such as agriculture, mineral mining, or oil drilling. They might show potential for becoming newly industrialized countries, but typically lack the necessary resources and skills to do so. Most lists of developing countries include many nations in Africa, the Middle East, and the poorest formerly communist nations in Eastern Europe and Asia.

**26) Does greater economic freedom guarantee a higher standard of living? Provide examples of two specific countries to support your answer.**

Answer: Factors making up each country's economic freedom rating include trade policy, government intervention in the economy, property rights, black markets, and wage and price controls. Most developed economies are rated completely "free" or "mostly free."

It can only be said that countries with the greatest economic freedom tend to have the highest standards of living, whereas those with the lowest freedom tend to have the lowest standards of living. The United States and Zimbabwe are two examples: the U.S. has high economic freedom and a high GNI, while Zimbabwe has low economic freedom and a low GNI.

Greater economic freedom does not guarantee a high per capita income, however. A country can rank very low on economic freedom yet have a higher per capita income than a country with far greater freedom. Saudi Arabia, for instance, has relatively low economic freedom with a relatively high GNI.

# Quiz questions

**27) \_\_\_\_\_ is the process by which a nation changes its fundamental economic organization and creates new free-market institutions.**

- A) Central planning
- B) Economic transition
- C) Industrialization
- D) Economic liberalism

Answer: B

**28) Which of the following is a major obstacle to economic transition?**

- A) lack of government support
- B) environmental degradation
- C) privatization
- D) black markets

Answer: B

29) Economic transition is the process of moving from \_\_\_\_\_.

- A) developed to developing economies
- B) centrally planned to free-market economies
- C) developed to emerging economies
- D) free-market to centrally planned economies

Answer: B