Prof. Dr. Karl-Heinz Paqué **Winter Term 2009/10**

Examination
for the lecture
"Introduction to International Economics"
(11038)

Preliminary Remarks:

- **Time**: 2 hours
- **Aids:** no aids are allowed, except a bilingual dictionary.
- **Language:** English. Answers in German are possible for students who are registered in German-speaking programs of the University.
- **Structure:** 2 parts (I, II). Part I consists of 30 multiple choice questions (1-30) and part II consists of two questions (1, 2). In part I, all multiple choice questions are weighted equally. For each right answer 2 points are given, for each wrong answer 1 point is *subtracted*, whereas no answer allows for 0 points. There is only *one* right answer for each question. If the total sum of points is *negative*, then *0* points will be accounted for Part I. In part I, a maximum of 60 points can be reached. In part II, both questions are to be answered using standard tools of economic reasoning. In each question, a maximum of 30 points can be reached. The total number of points is 120.

Part I (60 points):

Please check the right answer with **X** in the table below:

	A	B	C	D	E
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	A	B	C	D	E
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Table 1	*Labor productivity*	
	Cloth	Wine
Home	1/2	1/3
Foreign	2	1

1 Given the information in Table 1 above,

A) Home should export cloth
B) Foreign should export wine
C) Home should export wine
D) Home should export both, cloth and wine
E) Foreign should export both, cloth and wine

2 Given the information in Table 1 above, if Foreign's economy suffered a meltdown, and the *unit labor requirements* doubled to 1 for cloth and 2 for wine in Foreign, then

A) Home should export cloth
B) Foreign should import wine
C) Home should import wine
D) Foreign should import cloth
E) Foreign should export both, cloth and wine

3 Given the *initial* information in Table 1 above, if the world equilibrium price for cloth were 0.6 wine, then

A) Home could benefit from trade
B) Foreign could benefit from trade
C) neither country could benefit from trade
D) each country will want to export the good in which it has a comparative advantage
E) neither country will want to export the good in which it has a comparative advantage

4 Given the *initial* information in Table 1 above, if the world equilibrium price for cloth were 4.6 wine, then

A) Foreign will produce both, whereas Home only cloth
B) Foreign will produce both, whereas Home only wine
C) Home will produce both, whereas Foreign only cloth
D) Home will produce both, whereas Foreign only wine
E) both countries will produce only cloth

5 **The pauper labor argument, which asserts that foreign competition is unfair and hurts other countries when it is based on low wages,**

A) is a theoretical limitation to the applicability of the Ricardian concept of comparative advantage
B) is always relevant
C) is relevant because the Ricardian model allows for different technologies in different countries
D) is theoretically irrelevant to the Ricardian model and does not limit its logical cogency
E) none of the above

6 **According to the Heckscher-Ohlin model, comparative advantage is gained through**

A) differences in tastes
B) differences in labor mobility constraints
C) differences in technologies
D) differences in factor endowments
E) all of the above

7 **The Heckscher-Ohlin model states that a country will have a(an)..........in the good or service whose production is relatively .... in the..........in which the country is relatively.........**

A) absolute advantage, intensive, technology, abundant
B) advantage, abundant, tastes, intensive
C) comparative advantage, abundant, factor of production, intensive
D) comparative advantage, intensive, factor of production, scarce
E) comparative advantage, intensive, factor of production, abundant

Table 2	Countries	
Factor Endowments	England	Germany
Labor Force	120	20
Land Stock	80	80

8 **Refer to Table 2 above. If good G is produced land intensively, then following the Heckscher-Ohlin theory:**

A) There will be no trade between these two countries
B) England will export good G
C) Germany will export good G
D) Both countries will export good G
E) The information is not sufficient to draw any of the above conclusions

9 **Refer to Table 2 above. Suppose that in Germany the real value of production is equal to 220 whereas in England it is equal to 380. By knowing that the real rent of land is equal to 2 in Germany and the real wage to 0.5 in England, which of the following will be a plausible consequence of trade in the Heckscher-Ohlin model?**

A) The real wage has become 2, whereas the real rent of land 3
B) The real wage has become 4, whereas the real rent of land 1
C) The real wage has become 0.25, whereas the real rent of land has become 5
D) The real wage has become 2, whereas the real rent of land 5
E) None of the above

10 **If in the above example trade opens up between Germany and England, then**

A) landowners can be expected to complain about free trade
B) workers can be expected to support free trade
C) English workers can be expected to complain about free trade
D) German workers can be expected to support free trade
E) German landowners can be expected to support free trade

11 **In the Heckscher-Ohlin model, trade is beneficial because**

A) it increases the consumption level of all goods
B) it allows to reach a higher utility level
C) it decreases the real income of the scarce factors in society
D) both A and B
E) both B and C

12 **The concept of "Terms of Trade" is defined as**

A) the equilibrium world price
B) the amount of exports sold by a country
C) the amount of imports bought by a country
D) the price of a country's exports divided by the price of its imports
E) all of the above

13 **France produces two goods, cloth (C) and food (F) with prices P_C and P_F, respectively. If P_C/P_F were to increase in France, which is a major exporter of cloth, then**

A) France as well as its trading partners would be better off
B) the terms of trade of both France and its trading partners would deteriorate
C) the terms of trade of France will improve
D) the terms of trade of its trading partners will improve
E) none of the above

14 Refer to the example in question 13. If P_C/P_F were to increase in France with the income effect outweighing the substitution effect, then

A) the consumption of cloth will decrease, and the consumption of food will increase
B) the consumption of both goods will increase
C) the consumption of both goods will decrease
D) the consumption of cloth will increase, and the consumption of food will decrease
E) the information is not sufficient to draw any of the above conclusions

15 The Rybczynski theorem states: "If a factor endowment in a country………, and if the prices of the goods remain the same, then the output of the good that uses that factor intensively will……… while the output of the other good will………

A) rises, fall, rise
B) falls, rise, rise
C) falls, rise, fall
D) rises, fall, fall
E) falls, fall, rise

16 In the early 1990s, many observers began to warn that the growth of newly industrializing economies poses a threat to the prosperity of advanced nations. Which of the following answers could support this argument?

A) Immiserizing growth
B) Balanced growth
C) Export biased growth in newly industrializing economies
D) Import biased growth in newly industrializing economies
E) Import biased growth in advanced nations

17 In 1997 to 1998, several Asian nations, including Thailand, Indonesia, Malaysia, and South Korea, experienced a sudden reversal of international capital flows. These economies went quickly from receiving large inward transfers to making large outward transfers. If Keynes's presumption about the effects of transfers were right, this reversal of fortune should have produced

A) a deterioration of their terms of trade
B) an improvement of their terms of trade
C) a fluctuation of their terms of trade
D) a glut of their banking assets
E) none of the above

18 Assume Home is "large" relative to its trading partners. Assume further that Home imposes a tariff. The introduction of the tariff would lead to a decrease in domestic welfare if

A) the terms of trade rectangle exceeds the deadweight loss
B) the production distortion effect plus the consumption distortion effect exceed the terms of trade effect
C) the terms of trade rectangle exceeds the revenue triangle
D) the protective effect plus the revenue effect exceed the terms of trade effect
E) none of the above

19 If Armenia is a small country in world trade, then

A) the imposition of a tariff on its imports would cause an unambiguous fall in its national welfare
B) the imposition of a tariff on its imports would cause either a fall or an increase in its national welfare
C) the imposition of a subsidy on its exports would improve its national welfare
D) the imposition of a subsidy on its exports would have no effect on its national welfare
E) none of the above

20 If Russia were a large country in world trade, then

A) the imposition of a tariff on its imports would cause an unambiguous fall in its welfare
B) the imposition of a tariff on its imports would cause an unambiguous increase in its real income
C) the imposition of a subsidy on its exports would improve its welfare
D) the imposition of a subsidy on its exports would improve the real income of its trading partners
E) none of the above

21 A country's current account (CA) is equal to

A) Y-(C-I+G)
B) Y+(C+I+G)
C) Y-(C+I+G)
D) Y-(C+I-G)
E) none of the above

22 Which of the following statements is correct?

A) An appreciation of a country's currency makes its goods less expensive for foreigners
B) An appreciation of a country's currency raises the relative price of its exports and lowers the relative price of its imports
C) A depreciation of a country's currency makes its goods more expensive
D) A depreciation of a country's currency leaves foreigners unaffected, but makes the imports from abroad more expensive for domestic residents

E) A depreciation of a country's currency leaves the domestic residents unaffected, but makes its exports cheaper for foreigners

23 If the dollar interest rate is 7 percent per annum and the euro interest rate is 6.25 percent per annum, then

A) an investor should invest only in euros
B) an investor would find it costly to invest in dollars
C) an investor would prefer investing in dollar deposits rather than in euro deposits
D) an investor should be indifferent between investing in dollar or euro deposits
E) it is impossible to tell given only the information on interest rates

24 If the dollar interest rate is 7 percent per annum and the euro interest rate is 6.25 percent per annum, whereas the depreciation of the dollar against euro is 1 percent, then

A) an investor should invest in dollars
B) an investor should invest in euros
C) an investor should be indifferent between dollars and euros
D) an investor should invest neither in dollars, nor in euros
E) none of the above

25 If the dollar interest rate is 7 percent per annum, the euro interest rate is 6.25 percent per annum, the current exchange rate 1 dollar per unit of euro, what must be the expected exchange rate for the interest rate parity to hold?

A) The dollar should depreciate, and the expected exchange rate should become 1.5
B) The dollar should depreciate, and the expected exchange rate should become 1.75
C) The dollar should appreciate, and the expected exchange rate should become 1.5
D) The dollar should appreciate, and the expected exchange rate should become 1.75
E) The information is not sufficient to draw any of the above conclusions

26 Which of the following statements is correct?

A) For a given euro interest rate and constant expected exchange rate, a fall in the interest rate offered by dollar deposits does not affect the US dollar
B) For a given euro interest rate and constant expected exchange rate, a fall in the interest rate offered by dollar deposits causes the dollar to appreciate
C) For a given euro interest rate and constant expected exchange rate, a fall in the interest rate offered by dollar deposits causes the dollar to depreciate
D) A fall in the interest rate offered by dollar deposits causes the dollar to appreciate
E) A fall in the interest rate offered by dollar deposits causes the dollar to depreciate

27 Which of the following statements concerning PPP (purchasing power parity) is correct?

A) The law of one price applies to individual commodities while PPP applies to both the general price level and to individual commodities
B) In a competitive market free of transportation costs and barriers to trade, identical goods sold in different countries must sell for different prices when their prices are expressed in terms of the same currency, as stated by the law of one price
C) Under purchasing power parity, $E_{\$/€} = P_{EU}/P_{US}$
D) Absolute PPP implies relative PPP
E) All of the above

28 A decrease in the money supply in the US causes

A) an appreciation of dollar in the foreign exchange market
B) a depreciation of dollar in the foreign exchange market
C) no effect on the dollar value in international markets
D) a fluctuation of the dollar value in international markets
E) none of the above

29 Assume a long run open economy model. Due to an improving outlook of the economy, domestic investors increase their investments, which will cause

A) a revaluation of the domestic currency
B) a devaluation of the domestic currency
C) a net capital inflow
D) both A and C
E) both B and C

30 Assume a short run open economy model under flexible exchange rates. An increase in the money supply in the US will cause

A) a revaluation of the domestic currency
B) a devaluation of the domestic currency
C) a decrease in net exports
D) both A and C
E) both B and C

Part II (60 points):

Question 1 (30 points):

Of the many arguments in favour of tariffs, the one that has enjoyed a great popularity with economic theorists and policy makers is the *infant industry argument.*

(a) Explain verbally and show graphically the general case of a market failure as a justification for a tariff.
(b) Explain verbally and show graphically the role of the external economies and specialization in favor of the infant industry argument.
(c) Is the infant industry argument valid in practice? Discuss!

Question 2 (30 points):

Assume an open economy in the short run under a flexible exchange rate regime and the standard assumptions as specified in the lecture.
(a) Show graphically and explain economically the effects of an expansionary fiscal policy on the interest rate and output as well as the real exchange rate, domestic investment and net exports.
(b) Assume now perfect capital mobility. What are the results? Answer the question using graphics and economic reasoning.

End of the exam. Good luck!