Study Questions
(with Answers)

Lecture 4
Modern Theories and
Additional Effects of Trade

Part 1: Multiple Choice

Select the **best** answer of those given.

1. Which of the following is **not** a possible cause of a country having a comparative advantage in a particular good?

   a. Low demand for the good.
   b. Relative abundance of the factor of production used intensively in producing the good.
   c. A superior technology for producing the good.
   d. An unusually large number of firms producing the good.
   e. Relative scarcity of the factor of production that is not used intensively in producing the good.

   Ans: *d*

2. Which of the following is **not** normally regarded as a factor of production?

   a. Human Capital
   b. Land
   c. Money
   d. Labor
   e. Capital

   Ans: *c*

3. The presence of increasing returns to scale in an industry tends to

   a. Make that industry perfectly competitive.
   b. Discourage producers from exporting.
   c. Give a comparative advantage in that industry to large countries.
   d. Cause price in that industry to rise with output.
   e. Reduce industry costs the larger is the number of firms competing.

   Ans: *c*

4. According to the factor proportions model, countries have comparative advantage in the good that

   a. Employs a relatively large amount of their scarce factor.
   b. Employs a relatively large amount of the factor that they have relatively more of than other countries.
   c. Uses intensively their scarce factor.
   d. Requires proportionately more of every factor than the goods they import.
   e. Increases their proportional endowment of their scarce factor.

   Ans: *b*

5. Factor Price Equalization means that,

   a. All workers are equally productive.
   b. If a country fails to trade, its skilled workers will earn no more than its unskilled workers.
   c. Trade causes the return to human capital to be the same as the return to physical capital.
   d. For countries to trade freely, they must tax factors of production so that firms in all countries pay the same factor prices.
   e. Free trade causes identical factors in different countries to be paid more nearly the same than they were in autarky.

   Ans: *e*

6. Table 1 of Bivens, "Globalization and American Wages," shows calculated effects of globalization on incomes of US middle-income households in 1995 and 2006. Why is the effect in 2006 so much larger than in 1995?

   a. Because the share of less developed countries in trade was larger in 2006 than in 1995.
   b. Because US tariffs were much lower in 2006 than in 1995.
   c. Because many countries ceased buying US exports after the 1997 Asian Financial Crisis.
   d. Because countries in Europe adopted a common currency (the euro) in 1999.
   e. Because the ability of US labor unions to resist globalization was undermined by the Bush administration.

   Ans: a

7. Which of the following is one of the implications of the New Trade Theory?

   a. Countries as a whole must gain from trade.
   b. A country can only hurt itself by using government policies to promote exports.
   c. Consumers gain from the increased variety of goods that trade makes available.
   d. A country may export a good or import it, but not both.
   e. A tariff to protect an industry in a small country hurts demanders more than it helps suppliers.

   Ans: c

8. Which of the following best captures Krugman's view of the lesson of the New Trade Theory for trade policy, according to his article "Is Free Trade Passé"?

   a. Countries are almost certain to lose from trade unless their governments intervene.
   b. Countries may lose from trade, and are likely to lose if their governments pursue a policy of free trade.
   c. Countries may gain or lose from trade, and it does not much matter what the government does.
   d. Countries will most likely gain from trade, and in any case they are not likely to do better if their governments intervene.
   e. Countries necessarily gain from trade, and government intervention can only make matters worse.

   Ans: d

9. Which of the following is a distinctive implication of the <u>New</u> New Trade Theory (i.e., the Melitz Model), not present in the New Trade Theory?

   a. Trade increases average productivity as more productive firms expand to export.
   b. Consumers gain from the increased variety of goods that trade makes available.
   c. Trade encourages research and development and thus the creation of new products.
   d. A country may both export and import the goods from the same industry.
   e. A tariff to protect an industry in a small country hurts demanders more than it helps suppliers.

   Ans: *a*

Part II: Short Answer
Answer in the space provided.

1. Indicate, by circling the correct answer, what the Heckscher-Ohlin model predicts about the changes that will occur when a country opens up to international trade.

   a. Production of its export good will:

      expand contract stay the same *Ans: expand*

   b. Production of its import-competing good will:

      expand contract stay the same *Ans: contract*

   c. Demand for the country's abundant factor (at initial factor prices) will

      increase decrease stay the same *Ans: increase*

   d. The price of the scarce factor will

      rise fall stay the same *Ans: fall*

   e. The price of the abundant factor will

      rise fall stay the same *Ans: rise*

2. Demands for factors are sometimes said to be "derived demands". What are they derived from?

   Ans: Factor demands are derived from the demands for the outputs that they are used to produce.

3. According to the Stolper-Samuelson Theorem (circle the correct answers):

   a. Free trade benefits the [scarce / abundant] *(Ans: abundant)* factor and hurts the [scarce / abundant] *(Ans: scarce)* factor.

   b. A rise in the price of a good raises the real income of the factor that [is / is not] *(Ans: is)* used intensively in its production and lowers the real income of the factor that [is / is not] *(Ans: is not)* used intensively in its production.

4. The two statements in question 3 are actually equivalent because, in the HO model (circle the correct answers):

   a. Free trade raises the relative price, within the country, of the country's [export / import] *(Ans: export)* good and lowers the relative domestic price of its [export / import] *(Ans: import)* good.

   b. A country will export the good that uses its [scarce / abundant] *(Ans: abundant)* factor intensively in its production and import the good that uses its [scarce / abundant] *(Ans: scarce)* factor intensively in its production.

5. From the list below, select the **three** (3) assumptions that were introduced by the New Trade Theory and that were not made in previous trade models:

   ___✓___ Product differentiation
   ________ Factor proportions that differ across industries
   ___✓___ Imperfect competition
   ________ Firms in an industry are heterogeneous
   ________ Differences in unit labor requirements
   ________ Tariffs
   ___✓___ Increasing returns to scale
   ________ Constant returns to scale

6. Answer each of the questions below in the space provided, with a sentence or less (e.g., "Because…"):

   a. Why does the presence of imperfect competition create an additional opportunity for a country to gain from trade that would not exist if all markets were perfectly competitive?

      Ans: Because trade forces domestic firms to compete with foreign firms, increasing the degree of competition, and reducing the distortions caused by imperfectly competitive firms.

   b. How can the existence of some industries with increasing returns to scale and other industries with decreasing returns to scale cause a country to lose from trade?

      Ans: Because a small country will then have a comparative advantage in decreasing-returns sectors, and when it expands in order to export, its productivity will go down.

   c. How does the existence of industries with increasing returns to scale create an additional opportunity for the world to gain from trade?

      Ans: Because by specializing in a smaller number of industries, countries can produce more in each, and the costs of production will therefore fall.

7. Define the following terms:

   a. Autarky — *Ans: The situation in which a country does not engage in international trade; self-sufficiency.*

   b. Intra-firm trade — *Ans: Exports and imports that take place within a firm, such as sales by a foreign subsidiary back to the parent company.*

   c. Scarce factor — *Ans: A factor that a country has less of, compared to other countries, than it has of other factors; a factor that is relatively high-priced in autarky.*

d. Capital intensive industry *Ans: An industry that uses relatively more capital than other industries; an industry that employs a higher ratio of capital to other factors than is employed in other industries.*

e. Intra-industry trade *Ans: Export and import within the same industry.*

f. Strategic trade policy *Ans: The view that government policy can tilt the terms of oligopolistic competition to shift excess returns from foreign to domestic firms.*

g. Increasing returns to scale *Ans: The property that output rises more than in proportion to inputs when all inputs are expanded in the same proportion.*