

Midterm Exam
November 3, 2005

Answer in blue book. Use the point values as a guide to how extensively you should answer each question, and budget your time accordingly.

1. (8 points) A friend, upon learning that you are taking a course in international trade policy, has commented that he is very concerned about the large and growing US trade deficit. He suggests that the US should deal with this by levying an across-the-board tax on all imports. Will this work to reduce the trade deficit? Explain why or why not, including your reasoning and any conditions upon which the result may depend.
2. (12 points) What is the Most Favored Nation principle, and why is it useful in helping to move the world toward lower trade barriers? To what extent is it adhered to by the United States and other countries that are members of the World Trade Organization? Do departures from MFN mean that its intended role in fostering trade liberalization is not working?
3. (25 points) Suppose that a small country with perfectly competitive markets is initially importing 300,000 pounds of cheese each year subject to a 30% *ad valorem* tariff. It then restricts cheese imports further by imposing a quota that permits imports of only 180,000 pounds of cheese per year, while it continues also to levy the 30% tariff on these imports. Use supply and demand analysis to show the effects of this policy change on domestic and foreign people, firms, governments and countries as a whole, under each of the assumptions below about the administration of the quota. (Use either diagrams or equations, as you prefer, and indicate both the directions – gain, loss, or no change – and the sizes of the effects symbolically – that is, I'm not looking here for numerical answers.)
 - a. Import licenses are auctioned off in a competitive market.
 - b. Import licenses are given free to domestic firms that were previously importing the cheese into the country.
 - c. Import licenses are given free to foreign firms that were previously exporting the cheese to the country.
4. (15 points) Finland (this is true – see the Wall Street Journal November 1, 2005) requires that corn flakes breakfast cereal have added Vitamin D to make up for the sun deprivation of its Finnish people. Other countries (the Netherlands, according to WSJ) prohibit adding Vitamin D to cereals. Suppose that (from here on, I'm making this up – the reality is much more complicated) all other countries are like the Netherlands; that the market for cereal is perfectly competitive; and that Vitamin D can be added to cereal that has been produced for the world market by some simple process that costs \$0.02 per pound. Finland is a small

- country and takes as given the world price of cornflakes, which is \$2.00 per pound. The Finns produce no corn flakes and they are currently (in the presence of the Vitamin D requirement) buying 400,000 pounds of corn flakes each year, which is the only breakfast cereal that they care to eat. Their elasticity of demand for cornflakes is 2.0.
- a. Suppose that the EU declares the Finnish Vitamin D requirement to be illegal, so that it disappears. What will happen to Finland's imports of corn flakes? (I want a number, here.)
 - b. Discuss, and quantify to the extent you can, the welfare implications of removing the Finnish Vitamin D requirement.
5. (25 points) Show how use of an export subsidy by a country affects its terms of trade *and* its welfare in each of the following models:
- a. Small country, partial equilibrium
 - b. Large country, partial equilibrium
 - c. Large country, general equilibrium (the Standard Trade Model)
6. (15 points) Use Krugman's model of monopolistic competition (the model of Krugman-Obstfeld Chapter 6) to do the following. (There is no need to derive the model. Just use the equations and/or diagrams of the model directly, but be sure to define the terms and explain what you are doing.)
- a. Show that if two identical countries open to free trade in a differentiated product, the price of that product will fall.
 - b. Explain in words why this result occurs.
 - c. Identify which of the three characteristic assumptions of the New Trade Theory are needed for this result, and in each case explain why.