

Name _____

UMID _____

Midterm Exam
November 1 or 3, 2010

Answer on these sheets. Use the indicated point values as a guide to how extensively you should answer each question, and budget your time accordingly. The exam has a total of 60 points.

c. Continuing to ignore the exchange market, there must as discussed in class be some other transaction that also takes place, accompanying this one, that will keep credits and debits equal. For each of the following categories from the balance of payments, describe an example of such a transaction that would serve the purpose. The first is done for you, to illustrate.

i. The trade account. *Answer: the Japanese bond dealer who sells me the bonds accepts payment in dollars and uses them to buy a large number of iPhones from Apple in the US, intending to use them later as gifts, thus causing a (positive) export for the U.S. and a credit on the U.S. current account.*

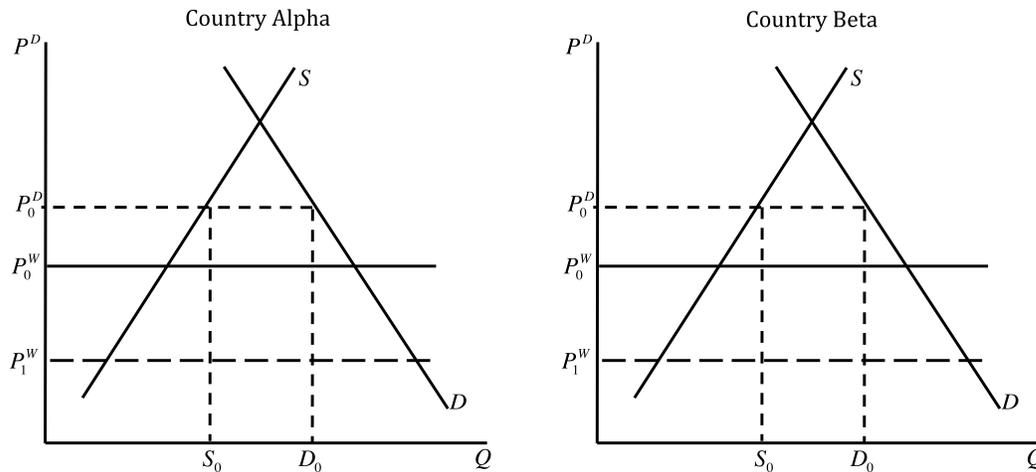
ii. Change in U.S. assets abroad.

iii. Change in foreign assets in the U.S.

iv. Transfer payments.

2. (9 points) Write a short essay explaining the Most Favored Nation principle. Include in your essay:
 - a. What the MFN principle says.
 - b. The role of MFN in US trade agreements prior to the GATT/WTO.
 - c. What MFN requires members of the WTO to do.
 - d. What exceptions from MFN are permitted by the WTO

3. (20 points) In alternate universes there are two almost identical small open economies, Country Alpha and Country Beta, whose markets for a good are shown below. Each faces the same initial world price for the good, P_0^W , and each is using a trade policy that causes the domestic price initially to be P_0^D , with quantities supplied and demanded, S_0 and D_0 . The one difference is that Country Alpha is using a specific tariff, while Country Beta is using a quota, with the import rights of the quota given away free to foreigners.



- a. How, if at all, do levels of initial welfare in these two countries (of suppliers, demanders, and government) differ, and why?
- b. Now suppose that, for both countries, the world price of the good falls from P_0^W to P_1^W , and that each country keeps its particular trade policy in place at the same size as before. Show in the two figures above the values after the world price change of domestic price, P_1^D , supply, S_1 , and demand, D_1 .

- c. Say in words and indicate also in the figures above, as appropriate, how the welfare of each of the constituencies (suppliers, demanders, and government) are affected by this fall in world price.

4. (10 points) In the space below, write a short essay describing the role that exchange rates are playing in the world economy today – specifically in the two months that this course has been underway. Which exchange rates are moving, and why? Which are not moving, and why? And what are governments saying about exchange rates?

5. (14 points) Using appropriate diagrams, fully labelled, analyze the effects of a tariff levied by Australia (a small country) on wine. Take carefull account of the fact that wine is a differentiated product, with Australian wine being viewed as not a perfect substitute for imported wine. However, the demand for each depends on the price of the other, as well as on its own price. Assume initially that the supply curve of Australian wine is upward sloping.
- a. Show how the tariff on imported wine will affect the price of Australian Domestic Wine in the Australian market (you can assume – sorry Ausie’s – that the Australian wine is not sold at all outside Australia).
 - b. How will the tariff affect the welfare of Australian wine consumers and Australian wine producers? What is the net effect of the tariff on the country of Australia as a whole?
 - c. How would your answers to parts (a) and (b) have been different if the Australian supply curve for wine had been perfectly elastic (i.e., horizontal)?

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