

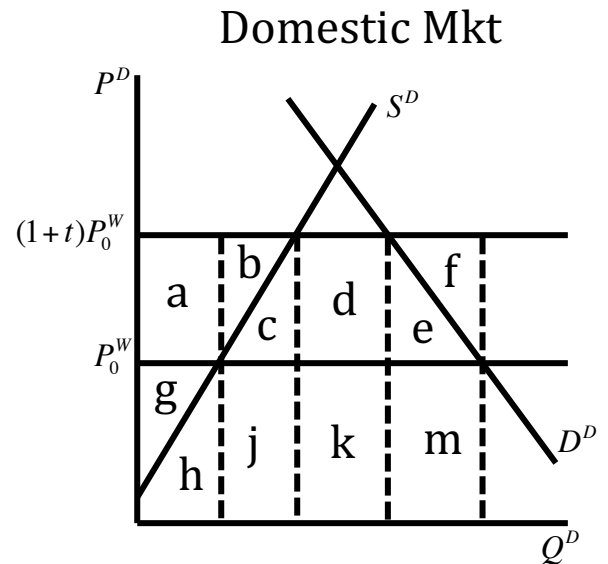
**Midterm Exam - *Answers***  
**October 31, 2019**

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. Note that the last page of the exam (page 8) is intentionally left blank for you to use if you run out of space to answer any of the questions, although I do not intend that you should need it.

The exam has a total of 60 points.

1. (10 pts.) Define any five (5) of the following seven terms. (If you answer more than 5, I will grade only the first 5, so be sure to cross out any answers you don't want me to grade.)
  - a. Vehicle currency: One that most currency exchanges are done in terms of, and also used to denominate contracts by parties outside the country of that currency
  
  - b. Balance on Financial Account: *Capital inflows minus capital outflows. Foreign purchases of domestic assets minus domestic purchases of foreign assets.*
  
  - c. Purchasing Power Parity: *A value of the nominal exchange rate that equates the price of a basket of goods in one currency to its price in the other.*
  
  - d. Specific tariff: *A tax on imports specified as units of currency per unit of the imported good.*
  
  - e. Gravity model: *A model that explains the volume of trade between two countries as proportional to the product of their GDPs and inversely proportional to the distance between them.*
  
  - f. National treatment: *Taxation, regulation, or other policies as applied to imported goods, once they have entered the country, that is the same as apply to domestically produced goods.*
  
  - g. Mercantilism: *The view, common before economists such as Adam Smith and Ricardo but still common today, that imports are bad and exports are good, both based on the understanding that trade is about trying to accumulate gold.*

2. (14 pts) The figure at the right shows the domestic market for a good in a small country, facing a world price of  $P_0^W$  and levying a tariff,  $t$ . Using the labeled areas in the figure, identify the following effects of the tariff compared to free trade always using a plus (+) or minus (-) sign to indicate the direction of the change):



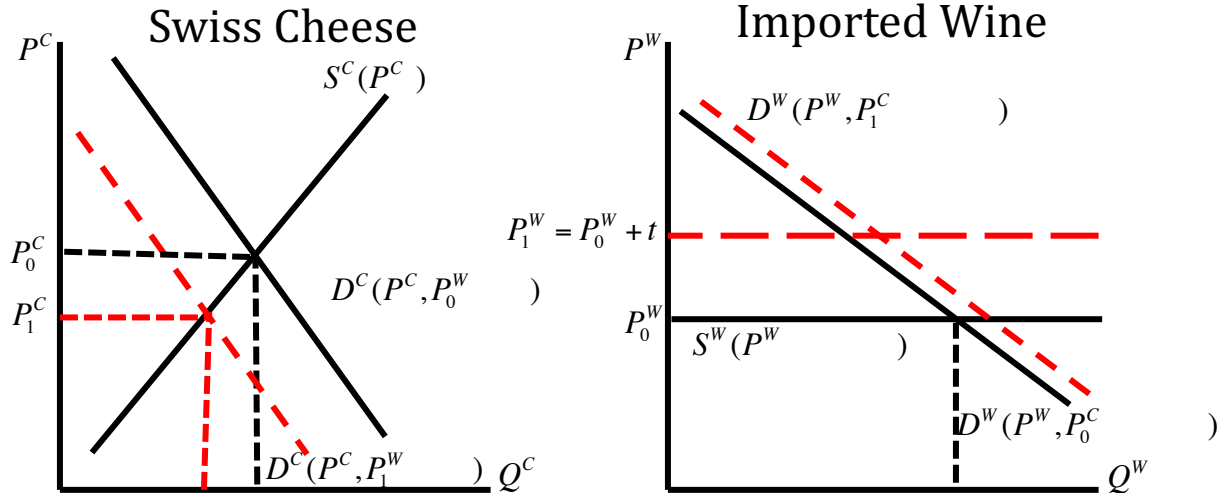
- a. The change in revenue of suppliers:  
 $+(a+b+c+j)$
- b. The change in total cost of suppliers:  
 $+(c+j)$
- c. The change in producer surplus of suppliers:  
 $+(a+b)$
- d. The change in expenditure by demanders:  
 $+(a+b+c+d)-m$
- e. The change in consumer surplus of demanders:  
 $-(a+b+c+d+e)$
- f. The change in tariff revenue:  
 $+d$
- g. The change in welfare of the country as whole:  
 $-(c+e)$

3. (4 pts) A basic result of simple models of microeconomics is that a monopoly produces a smaller output than would be optimal. A basic result of second-best trade theory is that a tariff or other trade restriction may be beneficial when it acts in the direction of correcting a market distortion. Is it therefore the case that, when an import-competing industry in a small open economy has only a single firm, a tariff – by expanding that firm’s output – may improve the country’s welfare? Why or why not?

*Ans: It is true that a tariff will expand the output of the domestic industry, even if that industry consists of only a single firm. The firm takes the price-with-tariff as given, and operates where its marginal cost equals that price. A rise in the tariff increases that price and causes the firm to move up its marginal cost curve to a higher output.*

*It is not the case, however, that this improves welfare. The reason is that, even though there is only a single firm in the industry, it is not able to operate as a monopolist since it has to take as given the price determined by the world price and the tariff. Thus, prior to the tariff it was not producing too little, and the fact that the tariff increases its output is not correcting any distortion.*

4. (12 pts) Switzerland produces no wine but it produces a lot of cheese, which for the purpose of this question it neither imports nor exports. Wine and cheese are complements. The graphs below show the Swiss domestic markets for (non-traded) cheese on the left, and for imported wine on the right, with wine infinitely elastically available for the world price  $P_0^W$ .



- Supply and demand curves are labeled in the figure, but their arguments have been omitted. Fill those in. That is, on what do each of these supplies and demands depend?
- Show in the figure the effects of a tariff on imports of wine and on the quantity and price of cheese. Who gains and who loses (no need to say how much) from the tariff?

*Ans: See above for quantities and prices. In the home country, suppliers of cheese lose (due to the fall in price). Those demanders who consume both wine and cheese, as suggested by their being complements, also lose from the rise in price of wine. Their loss is offset, but only partially, by the fall in price of cheese. If there are consumers who demand wine but not cheese, they too are worse off. Only consumers who buy only cheese, and no wine, benefit from the tariff, due to its effect on the price of cheese. Finally, the government and thus the tax payers benefit from the tariff revenue, so one could argue that people who consume no wine are better off, whether they consume cheese or not.*

- Is there anyone in this scenario who would be expected to lobby for this tariff?

*Ans: My answer would be no, since those who are most affected by the tariff (wine drinkers and cheese producers) lose. It's hard for me to imagine that either tax payers or those who consume cheese but not wine would be motivated to lobby for this tariff, but I can't say that you're wrong if you suggest that.*

5. (8 pts) Write a short essay on Trade Promotion Authority (aka Fast Track) and its relevance for trade policy in the world today. Include answers to the following questions:
- a. What is TPA?
  - b. Why is it needed?
  - c. Does it currently exist?
  - d. How does it matter for current policies and/or negotiations?

*Ans: Trade Promotion Authority, also called Fast Track, is a feature of US trade law under which Congress grants to the President the authority to negotiate trade agreements that Congress then promises to vote on up or down without amendments, subject also to specified deadlines.*

*It is needed so that the US can negotiate in good faith with other countries, who will know that any agreement reached with the US, while it may be rejected outright, will not be changed. Without that, it is argued that countries would be unwilling to negotiate.*

*TPA was approved by Congress under President Obama, and continues to be in effect under President Trump. It therefore is relevant for Congressional ratification of the renegotiated NAFTA, called USMCA. At the moment, while the process has begun, we seem to be currently waiting for the Trump administration to submit the implementing legislation to Congress, after which there will be a limited time by which Congress must vote.*

6. (12 pts) Write a short essay identifying and explaining events and actions during the last two years that may be contrary to the rules of the World Trade Organization and/or that may undermine the ability to the WTO to discipline international trade policy.

*Ans: The following could all be mentioned in answer to this question (I'm hoping that you will mention at least three of them):*

- *Trump's tariffs on imports of steel and aluminum, based their being a threat to national security. Although the WTO has a provision permitting tariffs on imports that threaten national security, it is unclear whether these tariffs will be judged legitimate, and whether they are or not, this is likely to diminish the effectiveness of the WTO.*
- *Trump's tariffs on China are based on US Section 301, claiming unfair trade practices by China with respect to intellectual property. Section 301 is not consistent with WTO rules.*
- *The retaliation, both by other countries against the tariffs on steel and aluminum and by China, are not permitted by the WTO, which requires instead that countries bring a complaint against the tariffs and only retaliate later if the US tariffs are ruled illegal and then are not removed.*
- *Trump has prevented new and renewed appointments to the WTO Appellate Body, which will as a result lack a quorum for making decisions later this year. That will prevent the WTO dispute settlement mechanism from functioning.*
- *China and the US disagree as to whether China was promised market-economy status some years after joining the WTO. US anti-dumping actions against China are therefore viewed by China as violating commitments that it was promised by the WTO.*
- *Trump has objected that the WTO allows countries to self-designate as developing countries, and he threatens to deny China and others of developing-country benefits that they believe they are entitled to.*
- *Trump threatened Mexico with tariffs on all imports if Mexico did not take actions to reduce migration through Mexico into the US. Had he done so, that would be been a blatant violation of WTO rules.*

*I would **not** regard the following as fitting this question, although I may be open to being persuaded otherwise.*

- *US tariffs on solar panels and washing machines are **not** contrary to WTO rules and therefore are not, at least directly, harmful to the WTO*
- *US tariffs on the European Union in retaliation against EU subsidies to Airbus are also not contrary to the WTO, and indeed were approved by the WTO. However, the size of this retaliation may perhaps prove a strain to the WTO system.*

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