The Final Exam is Tuesday May 4th at 1:00 in the normal Todd classroom

The final exam is comprehensive. The best way to prepare is to review tests 1 and 2, the reviews for Test 1 and Test 2, and the Aplia assignments that were reviews for Tests 1 and 2. The final exam will focus on the core concepts covered in international economics. Here we provide you with a guide through these topics. Some sample multiple choice questions (and answers) are included for students to diagnose the topics they have mastered and those where more work is needed.

1. Chapter 2: Understand absolute (from Smith) and comparative (from Ricardo) advantages, and compare them to the trade prescriptions made using the Mercantilist framework. Understand how opportunity cost is related to comparative advantage. Be able to explain the argument underlying Figure 2.1 (page 35) and Table 2.4 (page 37). Understand the trading possibilities line and the limits to the equilibrium terms of trade.

2. Chapter 3: Be able to explain the Heckscher-Ohlin (H-O) theory explaining the origins of comparative advantage. What does the term “labor abundant” mean in this model? In this model what types of products will a “labor abundant” country have a comparative advantage? Understand the factor price equalization theorem. In the world of H-O, opening trade according to comparative advantage, we can predict the effects on prices as trade opens. Understand the factor price equalization theorem. What is the Leontief Paradox? How is this related to predictions of the H-O theory?

3. Understand how the existence of scale economies, product differentiation, overlapping demands, can be used to understand intraindustry trade. Understand the term “intra-industry” trade and be able to explain why this is not fully explained by H-O.

4. Chapter 4: Understand and be able to use the small country model for analyzing the effects of a tariff. Understand the effect of a tariff on 1) consumer surplus, 2) producer surplus, and 3) efficiency. Be able to use the model shown in Figure 4.3 (page 123) to identify the consumption effect and the protection (production) effect of a tariff. Understand the differences between the small country model and the large country model. Show the protection and consumption effects of a tariff for a large country in Figure 4.4. What is the “terms of trade” effect? Identify the “terms of trade” effect in Figure 4.4. Is there a “terms of trade effect” in the small country model? Describe the tradeoffs involved when analyzing the optimal tariff for a large country.

5. Chapter 5: Understand the similarities and difference between an import quota and a tariff for the small country model. Identify the protection and consumption effects of a quota. Be able to analyze and compare the effects of a decrease in the world price on each model (tariffs versus quotas). Be able to analyze and compare the effects of a decrease in domestic demand in each model. Explain figure 5.2. Be able to use the small and large country models to analyze the effects of domestic subsides and export subsidies as presented in Figure 5.4 (page 160).

6. Chapter 8: Understand the distinctions between different regional trading agreements; free trade area, customs union, common market, economic union, and monetary union. Be able to understand and analyze the costs and benefits from joining a trading bloc. Understand the analysis presented in Figure 8.1 and identify trade creation and trade diversion effects.

7. Chapter 10: Be able to distinguish between the current account and the capital account. Be able to identify credits (inflow of home country’s currency) and debits (outflows). Be able to describe the term “official international reserves”. Explain the connections between a country’s current
account, financial (capital) account, and national saving. Be able to describe the recent trend in the US current and capital accounts. What is the world savings glut and how does this affect the US balance of payments?

8. Chapter 12: Understand the factors affecting exchange rates in the short run and in the long run. For the long run, be able to explain the law of one price (and the Big Mac Index example) and explain PPP. Understand table 12.2 (page 401) and the panels of Figure 12.2 (page 402). Understand the determination of short run exchange rates. Understand table 12.4 (page 410) and Figure 12.4 (page 411). Understand the phenomenon of exchange rate overshooting.

9. Chapter 13: Understand how the gold standard worked. Using the quantity theory of money explain how prices and interest rates adjust to trade surpluses and gold flows.

10. Chapter 14: Understand how exchange rate adjustments can affect the balance of payments. In particular be able to discuss the conditions under which a currency depreciation can reduce current account deficits. The discussion needs to use import and export elasticities (the Marshall Lerner Condition) the J curve effect, and partial passthrough.

11. Chapter 15: Explain the impossible trinity and apply it to the cases of Hong Kong, China, and the US. If a country wants a fixed exchange rate, what are its options? Understand the mechanics of a fixed exchange rate and the government intervention (using an exchange rate stabilization fund) required to defend the fixed rate. How does this affect a country’s domestic money supply? Understand the model used in figure 15.2. What are the advantages and disadvantages of fixed exchange rates? What are capital controls? Understand the terms currency board, dollarization, and seigniorage.

12. Chapter 16: Understand how the effects of macroeconomic policies (fiscal and monetary) are affected by the openness of the economy and the exchange rate regime (floating and fixed). Pay particular attention to Table 16.1 and be able to explain each of the four cases covered in that table.

Some Review Multiple Choice Questions

1. When countries trade according to each country’s respective comparative advantage
   a. The country that exports the most gains while the country that imports the most loses
   b. The country that imports the most gains while the country that exports the most loses
   c. Each country will capture some of the gains from trade
   d. If one country gains from the trade, the other country must lose an equivalent amount

2. Suppose country A has abundant labor and scarce capital. Product L requires labor intensive production. Product K requires capital intensive production. A result of free trade, in the long run
   a. Wages will decrease in country A
   b. The price of capital will decrease in country A
   c. The price of Product L will decrease in country A
d. The price of Product K will increase in country A

3. When a **large** country imposes an import tariff on good X
   a. World prices of good X decrease
   b. World prices of good X increase
   c. Consumer surplus in the large country increases.
   d. Domestic production of good X decreases

4. According to the factor price equalization theorem
   a. If factor prices are not equal then factors will migrate across borders
   b. If factor prices are not equal then firms will adjust production techniques
   c. Trade will result in a convergence of factor prices across borders
   d. Trade is a substitute for labor migration

5. Intra industry trade can be partly explained by
   a. The Heckscher Ohlin factor abundance theory
   b. The factor price equalization theorem
   c. Economies of scale in production
   d. Increasing opportunity costs

<table>
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<th>Labor hours to make:</th>
<th>In the United Kingdom</th>
<th>In the Rest of the World</th>
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<tr>
<td>1 umbrella</td>
<td>3.00</td>
<td>2.00</td>
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<tr>
<td>1 unit of corn</td>
<td>1.00</td>
<td>0.25</td>
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</table>

6. Refer to the table above. The United Kingdom has a comparative advantage in _______ and the Rest of the World has a comparative advantage in _______.
   a. Both goods; neither good
   b. Neither good; both goods
   c. Umbrellas; corn
   d. Corn; umbrellas
7. The figure above shows the domestic market for shoes in a small country. A tariff on shoes caused producer surplus in this country to ___ by an amount measured by area ______
   a. Fall; (a+b)
   b. Rise; (a+b+c+d)
   c. Fall; (a+b+c+d)
   d. Rise; (a)

8. When Leontief tested the predictions of the Heckscher-Ohlin theory, he found that in 1947 the United States was exporting relatively labor-intensive goods and importing relatively capital-intensive goods. This was called the Leontief Paradox. This finding:
   a. Contradicted the Heckscher-Ohlin theory as the United States was relatively capital-abundant.
   b. Contradicted the Heckscher-Ohlin theory as the United States was relatively labor-abundant.
   c. Justified the imposition of import tariffs on capital-intensive goods
   d. Fit the predictions of the Heckscher-Ohlin theory concerning the trading patterns of a capital-abundant country.

9. Zinhai is a small, exporting country in the world rice market. Recently the world price of rice increased from $500/metric ton to $1000/metric ton. Due to domestic protests about the rising price of rice, the Zinhai government imposed a ban on all exports. Under the export ban all domestic production will be sold to domestic consumers. As a result of this ban on Zinhai exports
   a. The domestic price in Zinhai will increase
   b. Domestic production in Zinhai will decrease
   c. Domestic consumption in Zinhai will decrease
   d. Domestic consumer surplus in Zinhai will decrease
10. Refer to the diagram above showing the domestic demand and domestic supply for product X in small country A. That is, country A is a small country in the world market for product X. The world price of product X is $2. If country A imposes a $2 per unit import tariff on product X
   a. Total tariff revenue will equal the size of the area \( \text{H+I} \)
   b. The production effect inefficiency will equal the size of area \( \text{G} \)
   c. The consumption effect inefficiency will equal the size of area \( \text{F+I+J} \)
   d. The decrease in consumer surplus will equal the size of area \( \text{E+F} \)
11. The US is a large country in the world oil market. The table below shows quantities of oil (in millions of barrels per day) for different prices. Currently the price of oil is $100 per barrel. If the US places a $50 per barrel import tariff on oil, the world price will decrease to $80, the US price would be $130 and the US would import 13 rather than 14 million barrels per day (mbd).

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<th>Price</th>
<th>Q supplied US</th>
<th>Q demanded US</th>
<th>Q Imported US</th>
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<td>$100</td>
<td>6 mbd</td>
<td>20 mbd</td>
<td>14 mbd</td>
</tr>
<tr>
<td>$130</td>
<td>6 mbd</td>
<td>19 mbd</td>
<td>13 mbd</td>
</tr>
</tbody>
</table>

a. The terms of trade effect would be about $100 million per day
b. The protection (production) effect would be $15 million per day
c. The consumption effect would be about $15 million per day
d. US producer surplus would stay the same

12. While import tariffs and import quotas can both be used to protect domestic producers, the import quota is the more effective policy when the policy goal is
a. To protect domestic producers from declines in the world price
b. To minimize the inefficiency of the trade barrier
c. To raise government revenue
d. To protect producers from declines in domestic demand

13. Which of the following capital transactions are entered as debits in the US balance of payments?
   a. A US resident transfers $100 from his account at Credit Suisse in Basel (Switzerland) to his account at a San Francisco branch of Wells Fargo Bank.
   b. A French resident transfers $100 from his account at Wells Fargo Bank in San Francisco to his Credit Suisse account in Basel.
   c. A US resident sells his IBM stock to a French resident.
   d. A US resident sells his Credit Suisse (in Switzerland) stock to a French resident.

14. Which of the following is considered a capital inflow?
   a. A sale of U.S. financial assets to a foreign buyer
   b. A loan from a U.S. bank to a foreign borrower
   c. A purchase of foreign financial assets by a U.S. buyer
   d. A U.S. citizen's repayment of a loan from a foreign bank

15. One difference between the trade balance and the current account is that
   a. The current account includes the flows of financial investment capital while the trade balance only includes the net interest income
   b. The trade balance includes imports and exports of services while the current account only includes capital inflows and outflows
   c. The current account includes net interest income while the trade balance does not
   d. The current account includes the government budget deficit while the trade balance does not
16. Currently the Yen/US$ exchange rate is 100Yen per $. The Japanese Central Bank announced (unexpectedly) that it would raise Japanese interest rates. As a result
   a. There would be an increase in the demand for the dollar and the price of the dollar would rise above 100 Yen
   b. The US dollar would appreciate (against the Yen)
   c. There would be an increase in the capital inflow into the US and out of Japan
   d. At the new exchange rate, Japanese exports would be more expensive to US consumers

17. In referring to the figure above, if the British government wants to peg the exchange rate of the pound at $2.50 per pound, what action would British monetary authorities have to undertake?
   a. Sell 1 million pounds and buy 2.5 million dollars.
   b. Buy 1 million pounds and sell 1 million dollars.
   c. Buy 1 million pounds and sell 2.5 million dollars.
   d. Buy 5.5 million pounds and sell 11 million dollars.

18. In recent years the US Balance of Payments has shown
   a. A capital (financial) account surplus
   b. A current account surplus
   c. Interest payments (to foreign countries) exceeded US interest receipts
   d. A large and steady outflow of gold
19. A country experiencing a capital account surplus:
   b. Is able to lend internationally.
   c. Experiences capital inflows
   d. Has a current account surplus

20. An increase in U.S. capital inflows will be associated with
   a. An increase in the US current account surplus
   b. An increase in US interest rates
   c. A decrease in the expected value of the US dollar
   d. Higher foreign interest rates

21. One disadvantage of a currency board (like the one in Hong Kong)
   a. The country loses the ability to control domestic interest rates
   b. There is greater exchange rate uncertainty
   c. It causes current account deficits
   d. It reduces foreign investment

22. In several economies we have observed two things going on at the same time: accumulation of foreign reserves and rising domestic inflation. This is unusual but can be explained as instances where
   a. Governments are increasing their own money supply to maintain an exchange rate peg that undervalues their own currency
   b. Governments with high unemployment rates raise interest rates to raise rates of return, and increase labor demand
   c. High domestic interest rates have led to excessive foreign borrowing
   d. Foreign lenders have sold their assets anticipating that “the bubble will burst” and the currency will depreciate

23. The law of __________ states that a product that is easily and freely traded in a perfectly competitive global market should have the same price everywhere.
   a. International trade
   b. One price
   c. Diminishing returns
   d. Interest rate parity

24. _________________ states that a bundle of tradable products will have the same cost in different countries if the cost is stated in the same currency.
   a. Covered interest rate equilibrium
   b. Trade equilibrium
   c. The law of comparative advantage
   d. Purchasing power parity
25. Alphania wants to peg its currency (the alpha) to the Euro at 2€ per alpha. Currently, if there were no intervention by the Alphanian Central Bank the market exchange rate would be 1.8€ per alpha. To maintain its desired peg, the Alphanian Central Bank
   a. Lower Aphanian interest rates
   b. Sell some of its official reserves of € to purchase the excess supply of alphas
   c. Reduce import tariffs
   d. Increase the rate of growth in the money supply

26. According to the “Impossible Trinity”, it is impossible to do 3 things at the same time. These 3 Things are
   a. Free capital flows, free immigration flows, and free trade flows
   b. Government budget deficit, current account deficit, and negative personal savings
   c. Free capital flows, independent monetary policy, and fixed exchange rates
   d. Democracy, economic growth, and low corruption

<table>
<thead>
<tr>
<th>Period</th>
<th>Short Term Interest Rate</th>
<th>Annual Inflation Rate</th>
<th>Current Account as % of GDP</th>
<th>Exchange Rate Alphas per Beta</th>
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<td>1</td>
<td>2%</td>
<td>2%</td>
<td>0%</td>
<td>10%</td>
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<td>2</td>
<td>2%</td>
<td>7%</td>
<td>0%</td>
<td>10%</td>
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27. The table above shows data for country A and country B. Country A’s currency is the Alpha and country B’s currency is the Beta. According to the theory of purchasing power parity,
   a. In the long run, the exchange rate (Alphas per Beta) will fall below 100 Alphas
   b. In the short run Country A’s current account will return to 0% of GDP
   c. In the long run Country B’s interest rate will equal Country A’s interest rate
   d. In the short run the exchange rate (Alphas per Beta) will rise above 100 Alphas

28. If a person in the US receives dividends from stocks they own in a Japanese company, this shows up in the US balance of payments as a
   a. Credit in the current account
   b. Debit in the investment account
   c. Credit in the capital account
   d. Debit in the capital account

29. Zetania is a country with a floating currency, the Zeta. The Zetanian government does not intervene in the currency markets so the exchange rate (currently $6 per Zeta) is determined by market forces. If the Zetanian economy had unexpectedly high rates of inflation then, in the long run
   a. Demand for the Zeta would decrease and the exchange rate would fall below $6
   b. Demand for the Zeta would increase and the exchange rate would rise above $6
   c. There would be an excess supply of Zetas
   d. There would be an excess demand for Zetas
30. The currency in Alphania is the Alpha. Currently the exchange rate is set so that 3 Alphas = 1 US$. An Ipod sells for 600 Alphas in Alphania. The same Ipod sells for $100 in the US. According to the law of one price, then either the price of Ipods in Alphania should ____________ and/or the exchange rate (Alphas/US$) should ________________
   a. Fall, fall  
   b. Fall, rise  
   c. Rise, fall  
   d. Rise, rise

31. In Country A, the government has a government budget deficit (tax revenues < government expenditures). Country A has a surplus on its current account. Country A will have a _________ in its financial (capital) account.
   a. Surplus  
   b. Depreciation  
   c. Deficit  
   d. Balance

32. Holding everything else constant, an increase in interest rates in the United States will lead to:
   a. Depreciation of the dollar.  
   b. Outflows of capital from the United States.  
   c. Capital inflows into the United States.  
   d. A decrease in the demand for dollar-denominated financial assets.

33. Under the gold standard, if Country A has a trade deficit with the ROW
   a. Gold will flow from the ROW to Country A and prices in Country A will rise
   b. Gold will flow from the ROW to Country A and prices in Country A will fall
   c. Gold will flow from Country A to the ROW and country A’s money supply will increase
   d. Gold will flow from Country A to the ROW and country A’s money supply will decrease

34. Recently China has had a current account surplus and a pegged exchange rate with the US. As a result
   a. Foreign reserves in China have increased and the Chinese money supply has increased
   b. Foreign reserves in China have increased and the Chinese money supply has decreased
   c. Foreign reserves in China have decreased and the Chinese money supply has increased
   d. Foreign reserves in China have decreased and the Chinese money supply has decreased
35. The currency of country Z is the Zeta. The currency of the rest of the world is the $. Country Z has a large stabilization fund ($30 billion) that they use to fix the exchange rate of the Zeta at $5 per Zeta. Due to a world recession, exports from country Z decreased, and so the demand for the Zetas decreased by 4 billion zetas, from $D_0$ to $D_1$. To keep the exchange rate at $5 Country Z will
   a. Sell 4 billion Zetas and buy 20 billion to add to their stabilization fund
   b. Sell 20 billion from their stabilization fund and buy 4 billion Zetas
   c. Sell 2 billion Zetas and buy 10 billion to add to their stabilization fund
   d. Sell 10 billion from their stabilization fund and buy 2 billion zetas

36. Under a system of floating exchange rates, relatively high productivity and low inflation rates in the United States result in a(n):
   a. Increase in the demand for the US$, and a depreciation in the dollar
   b. Increase in the demand for the US$, and an appreciation in the dollar
   c. Decrease in the demand for the US$, and a depreciation in the dollar
   d. Decrease in the demand for the US$, and an appreciation in the dollar

37. The “impossible trinity” describes several feasible exchange rate systems.
   I. Fixed exchange rate, capital controls, independent monetary policy
   II. Flexible exchange rate, no capital controls, independent monetary policy
   III. Fixed exchange rate, no capital controls, no independent monetary policy
   Which of the following is the best match?
   a. I. US  II. Hong Kong  III. China
   b. I. US  II. China  III. Hong Kong
   c. I. China  II. US  III. Hong Kong
   d. I. Hong Kong  II. US  III. China
38. Which of the following best describes China’s exchange rate policy:
   a. The RMB is currently pegged to the Euro
   b. The RMB is currently pegged against a market basket of currencies (US$, Hong Kong $, Japanese Yen, and Euro) weighted by the % of trade conducted in that currency.
   c. Throughout the 1980s, China gradually devalued the RMB ($/RMB $)
   d. During the last 6 months, the RMB has steadily depreciated against the $ ($/RMB $)

39. Currently the Peoples Bank of China is pegging China’s RMB to 6.85RMB/US$. Assume (as is widely thought) that the RMB is currently undervalued. To maintain the exchange rate at 6.85RMB/US$
   a. The Peoples Bank of China raises the interest rate on the RMB, this reduces the Chinese money supply
   b. The Peoples Bank of China buys RMB with $ from their official foreign reserves
   c. The Peoples Bank of China sells RMB and increases their official foreign reserves
   d. The Peoples Bank of China sells official foreign reserves

40. Suppose we observed two things going on at the same time in Country A: appreciation of the domestic currency (against the US$) and rising domestic inflation. This is can happen if
   a. Country A’s central bank increases their own money supply to maintain an exchange rate peg that undervalues their own currency
   b. High unemployment rates in Country A lead country A’s government to raise interest rates
   c. Current account deficits have led to excessive foreign borrowing
   d. Foreign lenders have sold country A’s financial assets anticipating that Country A’s currency will depreciate

Answers are on the next page.
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<th>Question</th>
<th>Answer</th>
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