

### Midterm Exam 2 Answers

The total time for the exam is 60 minutes, although you are given 70 minutes to complete it. Points are allocated proportionally to the time allocations. Answer all questions in your bluebook.

#### Part I: Multiple Choice [40 points]

1. If the tariff on computers is not changed, but the government then adds hitherto nonexistent tariffs on imported semi-conductor components, then the effective rate of protection in the computer industry will

- a. decrease**
- b. remain the same.
- c. increase.
- d. None of the above.

2. When the marginal social cost of producing widgets is less than the private marginal cost, then

- a. exports of widgets should be subsidized.
- b. exports of widgets should be taxed.
- c. production of widgets should be subsidized.**
- d. production of widgets should be taxed.

3. An Optimal Tariff

- a. refers to a situation when a tariff hurts a country's economic welfare.
- b. refers to a situation when the imposition of a tariff lowers domestic prices.
- c. could theoretically happen when a small country levies a tariff.
- d. None of the above.**

4. Monopolistic competition is associated with

- a. product differentiation.**
- b. high profit margins.
- c. explicit consideration at firm level of the feedback effects of other firms' pricing decisions.
- d. None of the above.

5. Intra-industry trade is most common in the trade patterns of

- a. developing countries of Asia and Africa.
- b. North-South trade.
- c. Trade between industrial countries.**
- d. None of the above.

6. Countervailing duties are intended to neutralize any unfair advantage that foreign exporters might gain because of foreign

- a. Local-Content legislation
- b. tariffs.
- c. export subsidies.**
- d. None of the above.

7. External economies of scale arise when the cost per unit

- a. rises as the industry grows larger, but average firm size remains constant.
- b. falls as the industry grows larger ~~rises as the average firm grows larger, but the average firm size remains constant.~~**
- c. falls as the average firm grows larger.
- d. remains constant.

8. Under U.S. commercial policy, which clause permits the modification of a trade liberalization agreement on a temporary basis if serious injury occurs to domestic producers as a result of the agreement?

a. Adjustment assistance clause

**b. Escape clause**

c. Most favored nation clause

d. Prohibitive tariff clause

9. Selling goods abroad at a price lower than sold at home

a. is sometimes called dumping.

b. never makes economic sense if the home firm is a monopolist.

c. is a manifestation of price discrimination, when the foreign market demand is more price elastic than the home.

**d. (a) and (c) above.**

10. Sovereign wealth funds are

a. the same as central bank reserves.

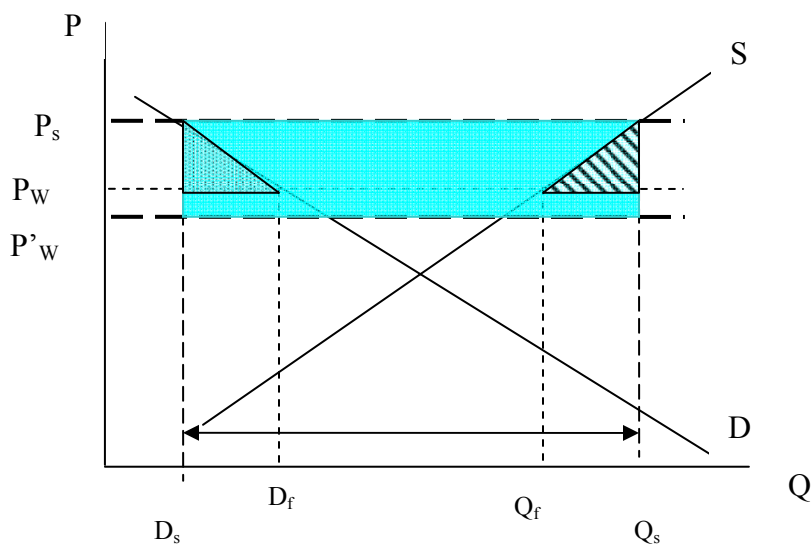
b. always attempt to maximize returns for the country that runs them.

**c. government owned holdings of assets.**

d. always run by developing countries and oil exporters.

**Part II: Short Answer [30 points**

1. (15 minutes) Consider the following diagram of a **large** country that exports widget. (The home widget industry is competitive.)  $P_w$  is the initial (free trade) world price of widgets.



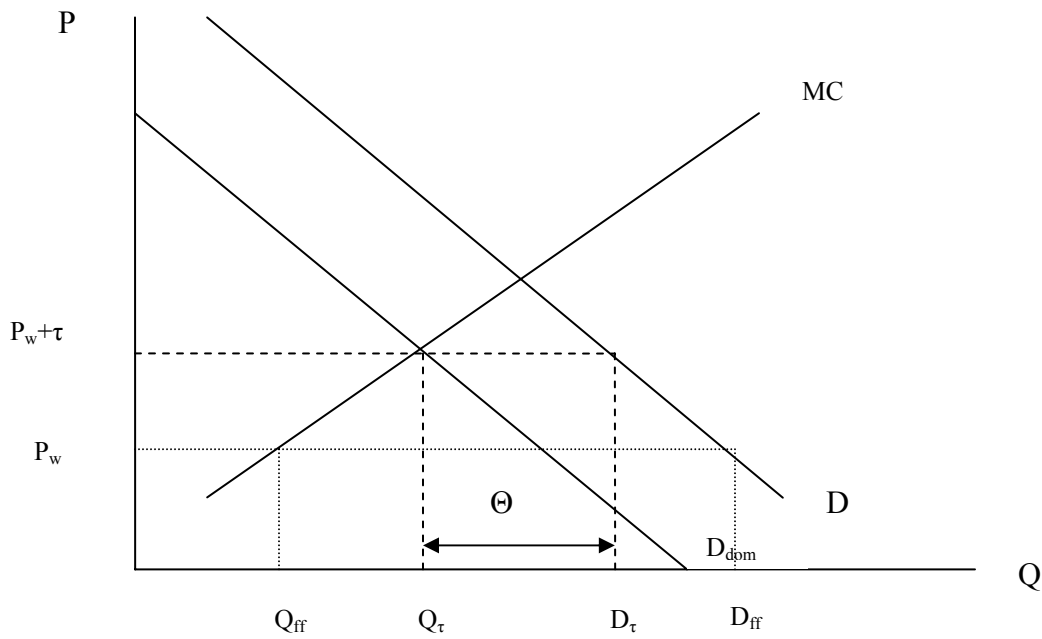
**Figure 1**

On newly drawn graph,

- 1.1 Show what happens to the quantity of exports if an *specific* export subsidy of amount  $s$ . Indicate the new quantities produced and demanded at home ( $Q_s$  and  $D_s$ , respectively), and the amount of exports. Also show the price at which shirts sell at home ( $P_s$ ). **Shown in Figure 1, as marked. New amount exported is shown by two-headed arrow.**
- 1.2 What is the expense to the nation's treasury? **Shaded area in box, in figure 1.**

- 1.3 What is consumption side dead weight loss? **Triangle dotted under Demand curve.**
- 1.4 What is the production side dead weight loss? **Triangle cross-hatched under Supply curve.**
- 1.5 Given these assumptions, can the country be made better of by imposing this export subsidy? **No, since the exports are being sold to the foreign country at a lower price than before, i.e., the terms of trade are deteriorated by the export subsidy. In addition, there are two dead weight losses, so national welfare unambiguously declines.**

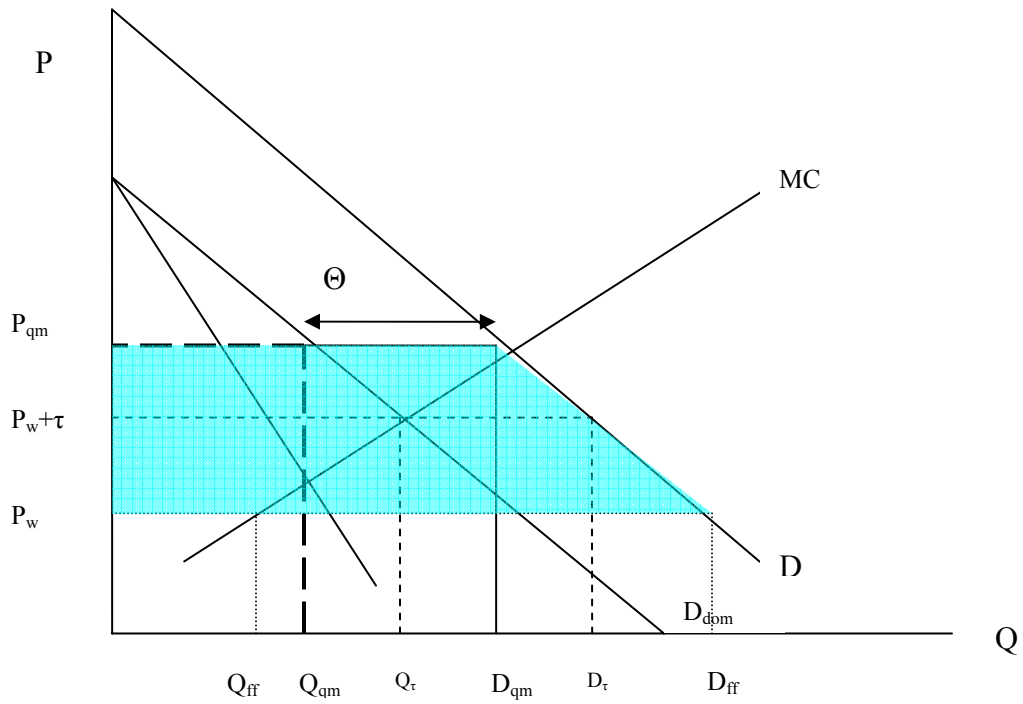
2. Consider the home shoe market with only one shoe producer. Assume further the country is small.
  - 2.1 Draw the supply, demand, and other relevant curves in a graph which shows the quantities produced and demanded at home ( $Q_{ff}$  and  $D_{ff}$ , respectively), and the amount of imports under free trade. Suppose a specific tariff is introduced. Indicate the new quantities produced and demanded at home ( $Q_{\tau}$  and  $D_{\tau}$ , respectively), and the amount of imports. **The new amount of imports is given by the distance of the two-headed arrow in Figure 2 below.**



**Figure 2**

- 2.2 Let the amount of imports in the previous question be  $\Theta$ . Now suppose that the government use a quota of  $\Theta$  amount of shoes instead of the tariff. Indicate the quantities produced and demanded at home ( $Q_{qm}$  and  $D_{qm}$ , respectively), and the amount of imports. In addition, indicate the price at which steel shoes will be priced at,  $P_{qm}$ .

**See Figure 3 below.**



**Figure 3**

2.3 Show the change in consumer surplus in 2.2 *relative to free trade*. **See shaded area in Figure 3; this area is the *reduction* in consumer surplus.**