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Name:.....

Section (number or time):

Econ 464
Fall 2007

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Exam 3 (80 pts)

(I) Intertemporal Trade

Consider the model of intertemporal trade developed in class. Assume there are two countries (call them "Now" and "Then") with nice PPF frontiers between present and future consumption good (corn). "Now" has a comparative advantage in the production of time 0 corn and "Then" has a comparative advantage in the production of time 1 corn. If a country borrows at time 0 from the other it will do so by issuing an IOU in exchange for the corn. If instead a country lends time 0 corn to the other, it will receive in exchange an IOU issued by the other country.

Assume that the free trade interest rate is identified as r^* and use the vertical axis for time 1 good and the horizontal axis for time 0 good.

- (1) **(6 pts)** Draw a diagram that shows Then's production and consumption points under free trade with Now. Identify the country's investment, exports and imports in both periods.
- (2) **(6 pts)** What are the signs of Then's current and financial accounts in each period? Where are the FA credits/debits in each period (i.e., in (5) or (6))?

Suppose that Then is suddenly afflicted by an insect that eats some of the planted corn (the time 0 corn endowment is not affected) so Then's investment is now less productive. Answer questions (3) and (4).

(3) **(12 pts)** What will happen to the equilibrium free trade interest rate? Justify using clear explanations, a diagram for Then and a Relative Supply/Relative Demand diagram for the world.

(4) **(6 pts)** What will happen to Now's consumption in periods 0 and 1 as a result of the change in the interest rate? Justify clearly using an explanation and/or diagram.

(II) (8 pts)

Consider a small country that imports beef from the rest of the world, has the standard domestic supply and demand curves and has a binding "quota" on imported beef (i.e. the amount of beef allowed under the quota is less than the amount that would be imported under free trade).

Suppose that suddenly the country is hit by "mad cow disease" (i.e. there is a negative shock to domestic supply of beef). Use a diagram to show what happens to the domestic price of beef.

(III) Short/Medium questions

(1) **(8 pts)** Consider the case of a small country. Use a diagram to show why a production subsidy is better for domestic welfare than an export subsidy.

(2) **(8 pts)** Define and discuss the differences between antidumping duties and the safeguards (also referred as the "escape clause").

(3) **(8 pts)** Identify under which circumstances a preferential trade agreement can be welfare improving although it results in trade diversion.

(4) **(6 pts)** Evaluate the following statement:

Increases in the government deficit always result in the deterioration of the current account

(5) For each of the following transactions identify the account in the US Balance of Payments where the credit and debit occur. Use the attached BOP for guidance with the accounts.

(A) **(4 pts)** A US firm exports computers to Germany. It receives payment in Euros.

(B) **(4 pts)** A Dutch resident buys Microsoft shares from a US resident and pays with dollars.

(C) **(4 pts)** A US resident buys shares of a Mexican firm and pays with dollars.