

You are not allowed to consult any notes or books. You have to write your answers in the blue book that the persons proctoring the exam give you. Your answers should reflect only your knowledge. Attempting to consult with others or to look at someone else's work constitutes academic misconduct.

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Name:.....

Section (number or time):

Econ 464

Spring 2010

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Exam 3 (Total Points: 70)

(I) Intertemporal Consumption Choice

Consider the model of used in class. As usual there are two countries (call them "Home" and "Foreign") with positive endowments of $t=0$ good that can be transformed into $t=1$ good.

The PPF frontiers between $t=0$ and $t=1$ good are "nice", Home has a comparative advantage in the production of $t=0$ good and Foreign a comparative advantage in the production of $t=1$ good. If a country borrows at time 0 from the other it will do so by issuing an IOU in exchange for the consumption good. If instead a country lends time 0 good to the other, it will receive in exchange an IOU issued by the other country.

Assume that the countries are trading in $t=0$ and $t=1$ goods and that the free trade interest rate is identified as r^* .

(1) (8 pts) Draw a diagram that shows Home's production and consumption points in both periods under free trade with Foreign (use the vertical axis for time 1 good and the horizontal axis for time 0 good). Identify physical investment in period $t=0$.

(2) (8 pts) Identify the sign of Home's current account and financial account in each period (use attached BOP for help with the FA signs). Use an equation to identify the relationship between the current account balances in the two periods.

Suppose that a technological breakthrough in the Foreign country makes physical investment more productive (i.e. the vertical intersection of the ppf shifts up). Answer questions (3) and (4) assuming that everything else remains the same.

(3) (8 pts) What will happen to the equilibrium free trade interest rate? Justify using a diagram of the World Relative Supply and World Relative Demand and a clear explanation.

(4) (8 pts) What will happen to Home's consumption in periods 0 and 1 as a result of the change in the interest rate? Justify your answer using a clear explanation.

(II) Cotton subsidies

The US is a large exporter of cotton and it subsidizes its cotton exports. Assume that the US removes this subsidy.

How will this subsidy removal affect:

1) (4 pts) the world price of cotton?

2) (8 pts) the welfare of other exporter countries like Brazil? (use a supply and demand diagram of the Brazil cotton market to show the changes in consumer surplus, producer surplus and total welfare).

(III) Medium/Short questions

- (1) **(5 pts)** Briefly explain what is the “Nondiscrimination” principle in the GATT/WTO .
- (2) **(6 pts)** Briefly explain under which circumstances a FTA will not result in trade diversion.
- (3) **(6 pts)** Give a short explanation of the relationship between the government deficit and the current account balance.
- (4) For each of the following transactions indicate on which account the credit and the debit occur in the US balance of Payments (identify the account number). Use the attached BOP for guidance with the accounts.

Here is the list of transactions you need to identify:

- (a) **(3 pts)** A US agent imports wine from Chile. He pays with dollars.
- (b) **(3 pts)** A US firm exports medical equipment to Italy. It gets payment in Euros.
- (c) **(3 pts)** A British Investment firm buys Intel shares, pays in dollars.

TABLE 12-2 Balance of Payments Accounts for 2006 (billions of dollars)		
	Credits	Debits
Current Account		
(1) Exports	+2,096.2	
Of which:		
Goods	+1,023.1	
Services	+422.6	
Income receipts	+650.5	
(2) Imports		-2,818.0
Of which:		
Goods		-1,861.4
Services		-342.8
Income payments		-613.8
(3) Net unilateral current transfers		-89.6
Balance on current account		-811.5
[(1) + (2) + (3)]		0
Capital Account		
(4)		-3.9
Financial Account		
(5) U.S. assets held abroad, excluding financial derivatives (increase -)		-1,055.2
Of which:		
Official reserve assets	+2.4	
Other assets		-1,057.6
(6) Foreign assets held in U.S., excluding financial derivatives (increase +)	+1,859.6	
Of which:		
Official reserve assets	+440.3	
Other assets	+1,419.3	
(7) Financial derivatives, net	+28.8	
Balance on financial account	+833.2	
[(5) + (6) + (7)]		
Statistical discrepancy		-17.8
[sum of (1) through (7) with sign reversed]		

Source: U.S. Department of Commerce, Bureau of Economic Analysis, June 15, 2007, release. Totals may differ from sums because of rounding.