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Economics 265-266

INTERNATIONAL TRADE

Comprehensive Exam

Do four questions in total with at least one chosen from each of the three sections. Put each question in a separate bluebook with your name on it.

Section I

Question 1:

In many less developed countries, a policy is established where tariffs and import quotas are imposed to protect manufactured goods. Needed industrial raw materials may be imported duty free.

(a) Starting from a position of free trade and a balance in international payments, how can one characterize the protective (or anti-protective) impact of tariff of 50% on one portion of the trade bill--say manufactured final consumption goods?

(b) Is your analysis of protection in part (a) dependent on the nature of the exchange-rate system--fixed or floating?

(c) Is your answer in part (a) dependent on the assumption of full employment of labor and capital?

(d) Is the tariff policy suggested in (a) likely to attract foreign capital from abroad?

Question 2:

Some economists argue that the underlying cause of the persistence of balance of payments problems in many European countries (for example, the United Kingdom and Italy) is the power of the trade unions to increase nominal wages without regard to market conditions, and the commitment of the government to full employment.

Consider an economy that produces two traded goods (the world prices of which are fixed) and one nontraded good. The exchange rate is fixed. In a situation of full equilibrium the nominal wage rate is permanently increased.

(a) What will be the long run effects of this wage increase if the government does nothing to maintain full employment?

(b) Analyze in detail the alternative fiscal measures that the government might undertake to preserve full employment. Consider also (briefly) the temptation to impose a tariff on imports to 'preserve jobs and balance of payments equilibrium.'

(c) What policy advice would you give to the government faced with the above situation? Is there an easy solution?

ADVICE: (1) Assume for convenience of diagrammatic exposition that the nontradable sector uses only labor as an input. Thus the nominal price of the nontraded good is proportional to the wage rate. Assume also that preferences are homothetic.

(2) This is not a difficult question. You should have encountered similar problems before.

Section II

Question 1:

The Swedish economist Sven Grassman has noted the "surprising" fact that about two-thirds of Swedish exports are invoiced in Swedish Kronor, and about two-thirds of imports are invoiced in the currency of the selling country. Prior to 1914 under the gold standard, almost all Swedish trade was invoiced in sterling. Grassman also noted that there has been a major shift in the composition of Swedish trade finance from precise 90-day trade bills and bankers acceptances towards "on account" credits (of indefinite maturity) from seller to buyer.

(a) Can these two empirical phenomena be related analytically?

(b) Would you expect this phenomenon of invoicing in the home currency to be a common practice in a country such as, say, India? How about Czechoslovakia?

(c) Is this recent Swedish data on the prevalence of invoicing in Kronor inconsistent with the notion of the U.S. dollar being a dominant international money?

Question 2:

The floating Canadian dollar from 1950-61 was notable for smoothness of daily or weekly movements in exchange rates; and for the fact that the Canadian dollar moved within a very narrow band relative to the American dollar--only $.96 to $1.04 U.S. during this ten-year period. This degree of exchange-rate stability was taken by many economists to be indicative of the smoothness of adjustment under more generally floating exchange rates.

(a) With the benefit of hindsight, why do exchange-rate movements across major convertible currencies seem much more pronounced now than in the older Canadian-American experience?

(b) Even without official parities, can central banks freely enter the foreign exchange market to "smooth" exchange-rate movements? Is it reasonable to portray these central bank interventions as being similar to that of private "stabilizing" speculations?

(c) Can general floating apply to less developed countries?

Question 3:

(a) Can "pure" fiscal policy be used more effectively to stimulate economic activity in an open economy in comparison to a closed one?

(b) How is your answer to (a) altered if the government issues money instead of non-monetary debt?

(c) The chronic balance of payments and balance of trade difficulties in post-war Britain have been attributed to a backward and non-innovative export sector which has failed to compete in international markets. Comment and criticize.

Section III

Question 1:

In what sense is free trade always the best policy? Why is it that governments interfere with free trade? In answering this question you should consider:

(a) The effect of trade on potential welfare (define it).

(b) The effect of trade on income distribution.

(c) One of the 'noneconomic' arguments for protection.

(d) One example of welfare reduction in the movement from autarky to free trade.

You may want to consider (briefly) the distinction between the welfare of a country and the welfare of the world economy. What general principles emerge from your discussion?

Question 2:

In most developing countries the wage rate in the urban sector is two or three times higher than the wage rate in the rural sector despite the presence of a large reservoir of unemployed labor in the urban areas. Does this fact provide a rationale for a policy of import substitution through tariff protection? Analyze this question in the light of the recent work of Harris and Todaro. You should consider the effect of an import tariff on unemployment and agricultural output. What would be the second-best policy, given the labor market distortion? Is it feasible?

Question 3:

You are hired by the World Bank to analyze the extent of protection in a developing country. You know the nominal tariffs on all commodities and have access to a rough estimate of the input-output matrix of the economy.

(a) How would you compute the effective rates of protection for various industries, assuming that the input-output coefficients are fixed?

(b) Consider only one intermediate input which is equally substitutable for labor and capital. How would you adjust for the possibility of substitution in your computation of the effective rate of protection.

(c) You find that in some industries the value added is negative when computed at world prices. Would you advise the government to close down these industries?

(d) Discuss very briefly how you would take care of nontraded goods and exchange rate adjustment. (No formulae expected.)

(e) What is, in your view, the usefulness of the concept of effective protection? When does it make sense? What would you expect to do with the ERP indices you have computed above?

Question 4:

Consider a small economy that receives a given amount of foreign aid which it uses to accomulate capital.

(a) What will be the effect of this capital transfer on the pattern of production and the volume of imports and exports, assuming that the import competing sector is capital intensive? Assume no tariff and given terms of trade in the world market. If the world terms of trade are free to move, which way would you expect them to move in each case?

(b) Assume that the country maintains a fixed tariff on imports. Show that it is possible that the capital transfer makes the country worse off. What would be the effect of the capital transfer in the presence of a fixed quota on imports? When would you in general expect 'immiserizing growth'?

(c) How could you tell from the observed data on national income, imports and exports and the rate of tariff whether welfare has increased or decreased? Under what conditions does the national income computed at world prices correctly predict the sign of welfare change?

ADVICE: Assume throughout the familiar neoclassical two-sector model.