Final Econ 2260 Driskill

1 Essays (short)

1. 10 points. Explain in one precise sentence what economists mean by "gains from trade."

2. 20 points. The author of "Travels" started her investigation because of concerns by her students about working conditions in the textile and apparel industries around the world. Based on your readings in "Travels," respond to the notion that rich-country consumers should boycott clothing made in less-developed countries because of working conditions in those locations.

3. 20 points. On page 156, the author of "Travels" poses the following question:

   "How did the United States–as the self-anointed free trade champion of the universe–end up with such a dauntingly complex and downright silly mass of barriers to the import of T-shirts? Why, in an era of progressive trade liberalization and increasing deference to the market mechanism, has the role of politics remained so pervasive in this industry?"

   Answer this question.

4. 10 points. The idea of "gains from trade" is *at best* viewed as concerning the **long-run** prosperity of a country. Why is this?

5. 20 points. How did the Reciprocal Trade Agreements Act help the United States lower tariff barriers?

6. True-false. 10 points total. Two (2) points for each correct answer. If you want, you can argue your case with a few short sentences of explanation for your choice.

   (a) _____In contrast to U.S. anti-dumping laws, the purpose of domestic anti-trust laws has been interpreted by the U.S. supreme court to be "the protection of competition, not competitors."

   (b) _____The Reciprocal Trade Agreements Act brought exporters into the political process as a "concentrated" interest group on the side of tariff reductions.

   (c) _____The World Bank, the IMF, and (eventually) the WTO, are known as the Bretton Woods institutions in honor of the English statesman Sir Bretton Woods who is usually credited as the architect of the agreements that led to the establishment of these organizations.

   (d) _____Economic theory tells us that in the long run, the bilateral current account balance between the U.S. and China should be zero.

(e) _____Warren Buffett is a Republican because he believes their stance on free trade promotes the well-being of the country better than the protectionist policies advocated by Democrats.

7. 10 points. As countries contemplated forming the Eurpean Common Market (forerunner to the EU), observers worried that resulting import competition in industries like the auto industry would unleash protectionary pressures that would make the ECM short-lived. Why were these observers wrong?

2 Macro

2.1 Money and nominal prices. 20 points.

1. Consider the monetary side of two real economies. Money demand is given as (we normalize real income to one (1)):

$$L^d = \frac{1}{2} P_I;\ L^{*d} = \frac{1}{2} P^*_{I^*},$$

where the price indices are given as a weighted average of the two nominal prices:

$$\begin{aligned} P_I &= \frac{1}{3}P_X + \frac{1}{3}P_M + \frac{1}{3}P_N; \\ P^*_{I^*} &= \frac{1}{3}P^*_X + \frac{1}{3}P^*_M + \frac{1}{3}P_N; \end{aligned}$$

Money supplies are exogenous and given as $\overline{L}$, $\overline{L}^*$, respectively:

$$\overline{L} = \overline{L}^* = 1.$$

In equilibrium, money demand equals money supply.

Relative prices are given as

$$\frac{P_X}{P_N} = \frac{P^*_X}{P^*_N} = \frac{P_M}{P_N} = \frac{P^*_M}{P^*_N} = 1.$$

Solve for P_N and P^*_N.

2.2 FX: 30 points.

In 1992, Britain was attempting to maintain a fixed exchange rate with respect to the German Deutschmark. It was also facing recessionary pressures, and did not want to raise its own interest rates. Germany raised its interest rate to finance reunification. Describe the problems this posed for Great Britain. Expository devices such as graphs would probably help your story.

2.3 BOP (we haven't done this yet)

Consider a hypothetical nation (say, the nation of Driskill) which has three citizens: Alex, Bobby, and Charley. This nation exists for two periods, period 1 and period 2. Alex exports $X_{Z,1}^{A}$ dollars worth of goods and services to citizens of the nation of Zeppos in period 1, and $X_{Z,2}^{A}$ dollars worth of goods and sevices to citizens of Zeppos in period 2. Alex also loans amount $LT_{B,1}^{A}$to bobby in period 1, and receives repayment amount $(1+r)LT_{B}^{A}$ from Bobby in period 2. Bobby imports $M_{Z,1}^{B}$ and $M_{Z,2}^{B}$ dollars worth of goods from the nation of Zeppos in periods 1 and 2, respectively. Bobby exports $X_{C,2}^{B}$ to citizens of country AF in period 2. Bobby also borrows amount $BF_{A,1}^{B}$ in period 1 and repays $(1+r)BF_{A,1}^{B}$ to Alex in period 2. Charley imports $M_{UT,1}^{C}$ dollars worth of goods and services from citizens of country UT in period 1 and exports $X_{MM,1}^{C}$ to citizens of country MM in period 1 and $X_{MM,2}^{C}$ in period 2. Charley also imports $M_{AF,1}^{C}$ and $M_{AF,2}^{C}$ from citizens of country AF in periods 1 and 2, respectively. Alex borrows amount $BF_{MC,1}^{A}$ from residents of country MC and repays $BF_{MC,1}^{A}(1+r)$ to these residents in period two. These are all the transactions that take place between citizens of our hypothetical nation and residents of other countries.

1. What is the aggregate budget constraint for the citizens of country 1 for period one and period two?

   Answer: First let's go individual by individual. In period one:

   $$\overbrace{X_{Z,1}^{A}+BF_{MC,1}^{A}}^{receipts} = \overbrace{LT_{B,1}^{A}}^{\exp enditures} \;;\; BF_{A,1}^{B}=M_{Z,1}^{B};\; X_{MM,1}^{C}=M_{UT,1}^{C}+M_{AF,1}^{C}.$$

   Aggregate (add up over all three):

   $$X_{Z,1}^{A}+X_{MM,1}^{C}+BF_{MC,1}^{A}=M_{Z,1}^{B}+M_{UT,1}^{C}+M_{AF,1}^{C}$$

   In period 2:

   $$\begin{aligned} X_{Z,2}^{A}+(1+r)\,LT_{B,1}^{A} &= (1+r)\,BF_{MC,1}^{A}; \\ X_{AF,2}^{B} &= M_{Z,2}^{B}+(1+r)\,BF_{A,1}^{B}; \\ X_{MM,2}^{C} &= M_{AF,2}^{C} \end{aligned}$$

   Aggregate:

   $$X_{Z,2}^{A}+X_{AF,2}^{B}+X_{MM,2}^{C}=M_{Z,2}^{B}+M_{AF,2}^{C}+BF_{MC,1}^{A}(1+r)$$

2. Show that the present value of exports equals the present value of imports.

   Answer: Solve each period budget constraint for $BF_{MC,1}^{A}$:

   $$BF_{MC,1}^{A}=\overbrace{M_{Z,1}^{B}+M_{UT,1}^{C}+M_{AF,1}^{C}}^{value\ of\ imports\ in\ pd\ 1}-\overbrace{\left[X_{Z,1}^{A}+X_{MM,1}^{C}\right]}^{value\ of\ \exp orts\ in\ pd\ 1}$$

$$BF^A_{MC,1} = \frac{1}{1+r}\left[X^A_{Z,2} + X^B_{AF,2} + X^C_{MM,2} - \left(M^B_{Z,2} + M^C_{AF,2}\right)\right]$$

Equate and rearrange to get:

$$\begin{aligned} & M^B_{Z,1} + M^C_{UT,1} + M^C_{AF,1} + \frac{1}{1+r}(M^B_{Z,2} + M^C_{AF,2}) \\ = \quad & X^A_{Z,1} + X^C_{MM,1} + \frac{1}{1+r}(X^A_{Z,2} + X^B_{AF,2} + X^C_{MM,2}) \end{aligned}$$

3. The bilateral trade balance surplus for any period is defined as the value of exports from one country to another minus the value of imports between the two countries. Must the country of Driskill have a zero bilateral trade balance surplus with the country of Zeppos?

   Answer: No. All that is required is that the present value of total exports equal the present value of total imports.

4. Why don't we need to record loans between members of country 1 in order to compute the aggregate budget constraints?

   Answer: They cancel out: a loan from citizen #1 to citizen #2 is an asset for #1 and a liability for #2.