

LO.a: Compare gross domestic product and gross national product.

1. The income of a country's citizens working abroad is included in it:
 - A. GNP, but not in GDP.
 - B. GDP, but not in GNP.
 - C. GDP and GNP.
2. Income to capital in the domestic country that is owned by foreigners is included in its:
 - A. GNP, but not in GDP.
 - B. GDP, but not in GNP.
 - C. GDP and GNP.
3. Which of the following is *least likely* correct about international trade terminology?
 - A. The difference between gross domestic product and gross national product is that GDP includes, while GNP excludes the production of goods and services by foreigners within that country.
 - B. The difference between terms of trade and net exports is that the terms of trade is the ratio of the price of exports to the price of imports, whereas net exports is the difference between the value of a country's exports and the value of its imports.
 - C. The difference between an autarkic economy and an open economy is that an autarkic economy has limited trade with only its neighboring countries, while an open economy can trade with any country of the world.

LO.b: Describe benefits and costs of international trade.

4. Which of the following is *not* a benefit of international trade?
 - A. Greater variety of products available to households and firms.
 - B. Increased competition and more efficient allocation of resources.
 - C. Countries receive lower prices for their exports and pay higher prices for imports.
5. Consider two countries that each produce two goods: tea and sugar. Suppose the cost of producing tea relative to sugar is lower in Tealand than in Sugarland. If the two countries start trading with each other, which of the following industries will *not* benefit from the trade in the short run?
 - A. Sugar industry in Tealand.
 - B. Tea industry in Tealand.
 - C. Sugar industry in Sugarland.
6. Which of the following is *least likely* to be a benefit of international trade?
 - A. Free flow of technical expertise.
 - B. Greater income inequality.
 - C. Increased efficiency.

LO.c: Distinguish between comparative advantage and absolute advantage.

7. For a country to gain from trade it must have:
- A. an absolute advantage.
 - B. a comparative advantage.
 - C. economies of scale or lower labor costs.
8. Three countries produce cloth and leather, and the output per worker per day in each country is as follows:

Country	Cloth	Leather
A	6	8
B	4	6
C	5	7

Which country *most likely* has the greatest comparative advantage for producing cloth?

- A. Country A.
 - B. Country B.
 - C. Country C.
9. Three countries produce cloth and leather, and the output per worker per day in each country is as follows:

Country	Cloth	Leather
A	6	8
B	4	6
C	5	7

Which country *most likely* has the absolute advantage for producing leather?

- A. Country A.
 - B. Country B.
 - C. Country C.
10. Pakistan exports cotton to Bangladesh and imports rice from Bangladesh. The following shows details of the output per worker per day:

	Cotton	Rice
Pakistan	6	12
Bangladesh	3	24

Which country has an absolute advantage as well as a comparative advantage in cotton?

- A. Pakistan.
- B. Bangladesh.
- C. Neither Pakistan nor Bangladesh.

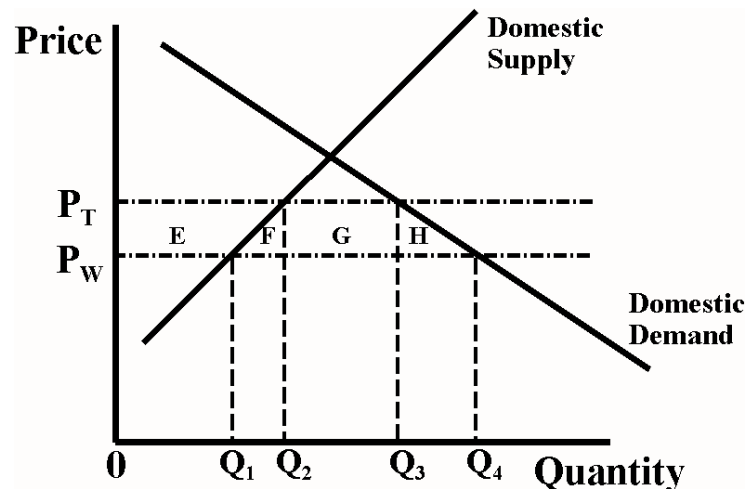
LO.d: Explain the Ricardian and Heckscher–Ohlin models of trade and the source(s) of comparative advantage in each model.

11. Consider two countries, X and Y. Country X is a closed country with a relative abundance of labor and holds a comparative advantage in the production of leather. Country Y has a relative abundance of capital. When the leather trade is opened between the two countries, Country X will *most likely* experience a favorable impact on:
- A. labor.
 - B. capital.
 - C. both capital and labor.
12. Statement 1: In the Ricardian trade model, a country captures more of the gains from trade if the terms of trade are closer to its autarkic prices than to its partner's autarkic prices.
Statement 2: In the Ricardian trade model, a country captures more of the gains from trade if the terms of trade are closer to its partner's autarkic prices than to its autarkic prices.
Which statement about the Ricardian model is *most likely* correct?
- A. Statement 1.
 - B. Statement 2.
 - C. None.
13. 'If a country did not have an absolute advantage in the production of any good, it could still gain trade if it had a comparative advantage in the production of a good, with labor being the only variable factor of production.'
The economist who made the above statement is *most likely*:
- A. Adam Smith.
 - B. Heckscher-Ohlin.
 - C. David Ricardo.
14. According to David Ricardo, comparative advantage is determined by:
- A. exchange rate.
 - B. net exports.
 - C. labor productivity.

LO.e: Compare types of trade and capital restrictions and their economic implications.

15. A small country has a comparative advantage in the production of wine. The government establishes an export subsidy for wine to promote economic growth. Which of the following will be the *most likely* result of this policy?
- A. As new domestic producers enter the wine market, supply will increase and domestic prices will decline.
 - B. The increase in the domestic producer surplus will exceed the sum of the subsidy and the decrease in the domestic consumer surplus.

- C. Although domestic producers will receive a net benefit, the policy will give rise to inefficiencies that cause a deadweight loss to national welfare.
16. A large country wants to increase its national welfare by imposing a tariff. Assuming its trading partner does not retaliate, which of the following conditions *must* hold in order for the large country to achieve its objective?
- It must have a comparative advantage in the production of the imported good.
 - The deadweight loss must be smaller than the benefit of its improving terms of trade.
 - It must auction the import licenses for a fee to offset the decline in the consumer surplus.
17. The diagram below shows the domestic demand and supply curves for a country that imports tea. P_w is the world price of tea and P_T is the domestic price of tea after imposition of a tariff.



- The total tariff revenue collected by the government is *best* described by the area(s):
- E.
 - G.
 - F+H.
18. The restriction on the quantity of goods traded imposed by an exporting country is known as:
- quota.
 - tariff.
 - voluntary export restraint.

The following information is for questions 19 - 21

Singapore manufactures 200,000 yards of cloth, but has a domestic demand of 325,000 yards of cloth. The world price of cloth is \$8 per yard and Singapore shall import 125,000 yards of cloth from the world market at free trade prices. The Singaporean government decides to impose a 20 percent tariff and the prices would increase to \$9.6 per yard. As a result, the domestic production will increase to 225,000 yards of cloth, while domestic demand will come down to 300,000 yards.

19. The gain in producer surplus is *closest* to:
- A. \$120,000.
 - B. \$340,000.
 - C. \$500,000.
20. The gain in government revenue is *closest* to:
- A. \$120,000.
 - B. \$340,000.
 - C. \$500,000.
21. The deadweight loss arising from the imposition of this tariff is *closest* to:
- A. \$40,000.
 - B. \$80,000.
 - C. \$120,000.
22. Which of the following statements is *most likely* correct about the effects of the alternative trade policies?
- A. An export subsidy decreases producer surplus.
 - B. An import quota increases producer surplus.
 - C. A tariff decreases government revenue.
23. Which of the following is *most likely* to decrease as a result of tariff?
- A. Domestic consumption.
 - B. Domestic production.
 - C. Price.

LO.f: Explain motivations for and advantages of trading blocs, common markets, and economic unions.

24. Three countries operate within a free trade area. One country proposes moving to a customs union structure. What additional level of economic integration between the countries would *most likely* arise if this change took place? They would:
- A. establish common trade barriers against non-members.
 - B. begin to allow free movement of the factors of production.
 - C. establish common economic institutions and coordination of economic policies.
25. Which of the following provisions is *not* included in a common market agreement?
- A. All countries adopt a common set of trade restrictions with non-members.
 - B. All barriers to import and export of goods and services among the countries are removed.
 - C. Member countries establish common institution and economic policy for the union.

26. If India and China have free trade with each other, a common trade policy against all other countries and free movement of factors of production between them, then India and China are part of a:
- A. free trade area.
 - B. customs union.
 - C. common market.
27. Which of the following is *most likely* correct regarding trade blocs?
- A. A customs union extends a common market by creating a common trade policy against non-members.
 - B. An economic union requires common economic institutions and coordination of economic policies among members.
 - C. A monetary union may or may not have a common currency.

LO.g: Describe common objectives of capital restrictions imposed by governments.

28. Analyst 1: Capital restrictions protect developing economies from large swings in asset prices.
Analyst 2: Capital restrictions cause large swings in asset prices in developing economies.
Which analyst is *most likely* correct?
- A. Analyst 1.
 - B. Analyst 2.
 - C. Neither.
29. Which of the following is *least likely* a capital restriction?
- A. Taxes on the income earned on domestic investments by domestic citizens.
 - B. Constraints on repatriation of earnings of foreign entities operating in a country.
 - C. Prohibition of foreign investment in certain domestic industries.
30. Trade diversion occurs when:
- A. the higher cost domestic production is replaced by lower cost imports from other members.
 - B. lower cost imports from nonmember countries are replaced by higher cost imports from members.
 - C. lower cost imports from member countries are replaced by lower cost domestic production.

LO.h: Describe the balance of payments accounts including their components.

31. Country A has a current account deficit. It will *most likely* still be able to consume more output than it produces by:
- A. increasing its net foreign liabilities.

- B. restricting foreign direct investment.
 C. adjusting interest rates to stimulate higher domestic savings.
32. An Indian firm purchases a patent for INR 25,000 and machinery for INR 30,000 from a U.S. firm. The impact of these transactions on the capital account of India (in INR) is *closest* to:
 A. 25,000.
 B. 30,000.
 C. 55,000.
33. A country's international transactions accounts data for last year are presented below in its domestic currency:

Transaction	Amount
Exports of goods and services	1,000
Import of goods and services	1,400
Investment income payments made to foreigners	250
Investment income received from foreigners	340
Net change in assets owned abroad	150
Net change in foreign-owned assets domestically	490
Unilateral current transfers received	34
Unilateral current transfers paid	110
Statistical discrepancy	64

The current account balance is *closest* to:

- A. -322.
 B. -386.
 C. -450.
34. During the last month, a pharmaceutical company located in India had the following transactions:

Transaction	Amount (INR millions)
Bought raw material from Pakistan	500
Sold products to United States	650
Received royalty fees from its branch in Sri Lanka	5
Donated to a charitable institution in Africa	1
Borrowed from a bank in the United Kingdom	2
Paid legal fees to its U.S. legal consultant company	12
Received interest coupon from its investment in Eurobonds	8

These transactions will *most likely* increase the Indian current account (in INR millions) by:

- A. 170.
- B. 150.
- C. 140.

35. Which of the following is *most likely* to be credited in a Balance of Payments account?

- A. Payment of debt by foreigners.
- B. Purchase of foreign financial asset.
- C. Value of imported goods and services.

LO.i: Explain how decisions by consumers, firms, and governments affect the balance of payments.

36. Which of the following statements about current account surplus/deficit is *most likely* correct?

- A. Low private saving tends to produce a current account deficit that is financed through high investment.
- B. A current account surplus is balanced by net capital exports.
- C. Current account deficit countries tend to enjoy lower risk premiums.

37. A country implements policies that are expected to increase taxes by €200 million, increase government spending by €100 million, and reduce investments and private sector savings by €50 million each. As a result, the country's current account balance will *most likely*:

- A. increase by €100 million.
- B. decrease by €100 million.
- C. increase by €200 million.

38. Low private savings and/or high investment tend to:

- A. produce a current account surplus that must be balanced by net capital exports
- B. produce a current account deficit that must be balanced by net capital exports.
- C. produce a current account deficit that must be balanced by net capital imports.

39. Analyst 1: All else equal, current account surplus countries tend to enjoy lower risk premiums than current account deficit countries.

Analyst 2: All else equal, current account deficit countries tend to enjoy lower risk premiums than current account surplus countries.

Which analyst is *most likely* correct?

- A. Analyst 1.
- B. Analyst 2.
- C. Neither.

LO.j: Describe the functions and objectives of the international organizations that facilitate trade, including the World Bank, the International Monetary Fund, and the World Trade Organization.

40. The International Monetary fund *most likely*:
- A. provides low interest rate loans to developing countries.
 - B. lends foreign currency on a temporary basis to address balance of payment issues.
 - C. provides a major institutional and regulatory framework of global trade rules.
41. The World Bank *most likely*:
- A. provides low interest rate loans to developing countries.
 - B. lends foreign currency on a temporary basis to address balance of payment issues.
 - C. provides a major institutional and regulatory framework of global trade rules.
42. The World Trade Organization *most likely*:
- A. provides low interest rate loans to developing countries.
 - B. lends foreign currency on a temporary basis to address balance of payment issues.
 - C. provides a major institutional and regulatory framework of global trade rules.
43. Which of the following international organizations provides a regulatory framework of global trade rules?
- A. International Monetary Fund.
 - B. World Bank.
 - C. World Trade Organization.
44. Which of the following organizations helps developing countries in fighting poverty?
- A. International Monetary Fund.
 - B. World Bank.
 - C. World Trade Organization.

Solutions

1. A is correct. The income of a country's citizens working abroad is included in its GNP, but not in its GDP.
2. B is correct. Income to capital in the domestic country that is owned by foreigners is included in its GDP, but not in GNP.
3. C is correct. An autarkic economy is a closed economy and does not trade with any country.
4. C is correct. Due to international trade, countries receive higher prices for their exports and pay lower prices for imports.
5. A is correct. The sugar industry in Tealand would not benefit from trade, at least in the short run. Since sugar is relatively expensive to produce in Tealand, the domestic sugar industry will shrink as sugar is imported from Sugarland.
6. B is correct. Greater income inequality is a cost of international trade.
7. B is correct. Even if a country does not have an absolute advantage in producing any goods, it can still gain from trade by exporting the goods in which it has a comparative advantage.
8. A is correct. A country has a comparative advantage if its opportunity cost of producing a product is less than the opportunity cost of its trading partners.

Country	Cloth	Leather	Comparative advantage (Leather/cloth)
A	6	8	1.33
B	4	6	1.50
C	5	7	1.40

9. A is correct. A country is said to have an absolute advantage in the production of a good if it can produce the good at a lower cost, in terms of resources than another country. Country A has the highest output per unit of labor.
10. A is correct. Pakistan has an absolute advantage in producing cotton because it produces more cotton per worker per day (6) compared to Bangladesh (3). Pakistan also has a comparative advantage in producing cotton because the opportunity cost of cotton in Pakistan ($12/6 = 2$) is lower than the opportunity cost of cotton in Bangladesh ($24/3 = 8$).
11. A is correct. As a country opens up to trade, the benefit accrues to the abundant factor, which is labor in Country X.

12. B is correct. In the Ricardian trade model, a country captures more of the gains from trade if the terms of trade are closer to its partner's autarkic prices than to its autarkic prices.
13. C is correct. David Ricardo extended Adam Smith's theory and made the given statement. According to Heckscher-Ohlin, capital and labor are both variable factors of production.
14. C is correct. According to David Ricardo, the comparative advantage is determined by differences in labor productivity due to differences in technology.
15. C is correct. Export subsidies interfere with the functioning of the free market and result in a deadweight loss to society. On the producer side, higher subsidized prices cause inefficient producers to remain in the market. On the consumer side, a higher price causes those that would have purchased at the lower price to be shut out of the market.
16. B is correct. The large country is able to cause the foreign exporter to reduce prices in order to retain market share. In the large country, domestic producers gain from higher volume and the government gains from collecting the tariff. The sum of these two gains must exceed the deadweight loss to domestic consumers to achieve a national welfare gain.
17. B is correct. The total tariff revenue collected by the government is represented by area G.
18. C is correct. A voluntary export restraint is imposed by the exporting country to restrict the quantity of goods traded.
19. B is correct.
- $$\text{Gain in producer surplus} = \frac{1}{2} * 1.6 * (225,000 - 200,000) + 200,000 * 1.6 = \$340,000$$
20. A is correct.
- $$\text{Gain in government revenue} = (\$1.6) * (300,000 - 225,000) = \$120,000$$
21. A is correct.
- $$\begin{aligned} \text{Dead weight loss} &= \frac{1}{2} * 1.6 * (225,000 - 200,000) + \frac{1}{2} * 1.6 * (325,000 - 300,000) \\ &= 40,000 \end{aligned}$$
22. B is correct. An export subsidy increases producer surplus, while a tariff increases government revenue.
23. A is correct. The domestic consumption decreases as a result of tariff. Domestic production and price increase due to tariff.

24. A is correct. A customs union structure incorporates all aspects of the free trade area and extends it by establishing common trade barriers against non-members.
25. C is correct. Member countries establish common institution and economic policy for the union is a provision included in an Economic union.
26. C is correct. A common market allows free movement of goods and services among members, a common trade policy against non-members and free movement of factors of production among members.
27. B is correct. A is incorrect because a customs union extends a free trade area by creating a common trade policy against non-members. C is incorrect because a monetary union adopts a common currency.
28. A is correct. Capital restrictions protect developing economies from large swings in asset prices.
29. A is correct. Taxes on the income earned on foreign investment by domestic citizens would be an example of capital restriction.
30. B is correct. Trade diversion occurs when lower cost imports from nonmember countries are replaced by higher cost imports from members.
31. A is correct. A current account deficit must be offset by a capital account surplus. Only by borrowing money from foreigners can a country have a current account deficit and consume more output than it produces. An increase in net foreign liabilities is the result of borrowing from foreigners.
32. A is correct. The purchase of machinery is an import and affects the current account, not the capital account, so it is ignored. The purchase of a non-produced, non-financial asset (such as a patent) affects the capital account.
33. B is correct.

Transaction	Amount	Totals
Export of goods and services and income receipts		1,340
Export of goods and services	1,000	
Investment income received from foreigners	340	
Import of goods and services and income payments		-1,650
Import of goods and services	-1,400	
Investment income payments made to foreigners	-250	

Net unilateral current transfers		-76
Unilateral current transfers received	34	
Unilateral current transfers paid	-110	
Current account balance		-386

34. B is correct.

Transaction	Amount (INR millions)
Bought raw material from Pakistan	-500
Sold products to United States	650
Received royalty fees from its branch in Sri Lanka	5
Donated to a charitable institution in Africa	-1
Borrowed from a bank in the United Kingdom	Omit
Paid legal fees to its U.S. legal consultant company	-12
Received interest coupon from its investment in Eurobonds	8
Total	150

35. A is correct. Payment of debt by foreigners results in a decrease in assets and hence is credited in the balance of payment account. Purchase of foreign financial assets and value of imported goods and services is debited in the balance of payment account.

36. B is correct. A is incorrect because low private saving tends to produce a current account deficit that is financed through net capital imports. C is incorrect because current account surplus countries tend to enjoy lower risk premiums.

37. A is correct.

$$CA = S_p - I + (T - G - R)$$

Where CA = Current account balance, S_p = Private sector savings, I = Investments, T = Taxes, G = Government spending and R = Transfers

$$\Delta CA = -50 - (-50) + (200 - 100 - 0) = 100$$

38. C is correct. Low private savings and/or high investment tend to produce a current account deficit that must be balanced by net capital imports.

39. A is correct. All else the same, a sustained current account deficit contributes to a rise in the risk premium for the financial assets of the deficit country.

40. B is correct. The IMF lends foreign currency on a temporary basis to address balance of payment issues.

- 41. A is correct. The World Bank provides low interest rate loans to developing countries.
- 42. C is correct. The World Trade Organization's mission is to foster free trade by providing a major institutional and regulatory framework of global trade rules.
- 43. C is correct. The World Trade Organization provides a regulatory framework of global trade rules.
- 44. B is correct. The World Bank helps developing countries fight poverty.