

Midterm Exam
November 2, 2011

Answer on these sheets. Use the indicated point values as a guide to how extensively you should answer each question, and budget your time accordingly. The exam has a total of 60 points.

1. (8 points) The United States is running a deficit on current account. In the space below, explain briefly:
 - a. What a deficit on current account means, by definition;
 - b. What it implies, if anything, for the US financial account;
 - c. What it implies, if anything, for US aggregate expenditure and income and/or savings and investment;
 - d. What it implies, if anything, for US and foreign trade policies.

2. (8 points) In the space below, briefly answer the following:
- a. What is the Law of One Price (LOP)?
 - b. Does the world obey the LOP, and on what do you base your answer?
 - c. How is the LOP related to the idea of Purchasing Power Parity (PPP)?
 - d. According to PPP, if inflation (the rate of increase in prices) in China is greater than inflation in the US, what should happen to the exchange rate between the US dollar and the Chinese currency, the yuan? Specifically, should the dollar appreciate or depreciate relative to the yuan?

3. (24 points) In the space below, draw a diagram depicting supply and demand for a good, under perfect competition, in a small country that imports the good under free trade.
 - a. (12 points) Use the diagram to show the effects of a non-prohibitive, *ad valorem* tariff, t_0 , on imports of that good as it will affect quantities of the good supplied, demanded, and imported, as well as on the welfare of suppliers, demanders, and the country as a whole. (Be sure to state clearly what these effects are; don't just expect me to read them from your diagram.)

- b. (8 points) Suppose that the main purpose of the tariff in part (a) was to raise revenue for the government. How would the use, instead, of a consumption tax (a tax on all demand for the good), also of *ad valorem* size t_0 , compare to the tariff of part (a)? Compare in terms of: revenue generated, welfare of suppliers, welfare of demanders, and welfare of the country as a whole?
- c. (4 points) Based on your analysis in parts (a) and (b), which policy would you advise a government to use in order to raise revenue? Why? Would you expect the government to follow your advice?
- d. (2 points extra credit) If the country had been large instead of small, how would this matter for the comparison of the effect of the tariff and consumption tax on welfare of consumers? Why?

4. (10 points) Recently, manufacturers of solar panels in the United States have requested that a tariff be levied on imports of solar panels from China.
- a. Explain a process within US trade law by which these manufacturers might pursue this request (this does not need to be the process that they actually are using). Include an explanation of who within the US government will handle this request and the role, if any, of the President.
 - b. If they succeed in getting such a tariff, how might China be able to respond, if at all, within the rules of the World Trade Organization? If they do respond how will their response be handled by the WTO?

5. (10 points) Identify any one (and only one) of the following three statements as True or False and provide an analysis, with an appropriate diagram and explanation, to justify your answer.
- a. A tariff cannot make a country better off.
 - b. If a tariff is replaced by an import quota – with the quota set equal to the quantity of imports that came in under the tariff – then consumers of the imported good may be worse off.
 - c. A tariff placed on imports of a good that is used as an input to another industry will hurt both suppliers and demanders in the using industry.

[This page intentionally left blank for your use if needed.]