

SPP/Econ 541 Lucia Tajoli and Alan Deardorff  
Fall Term 2012 Midterm Exam

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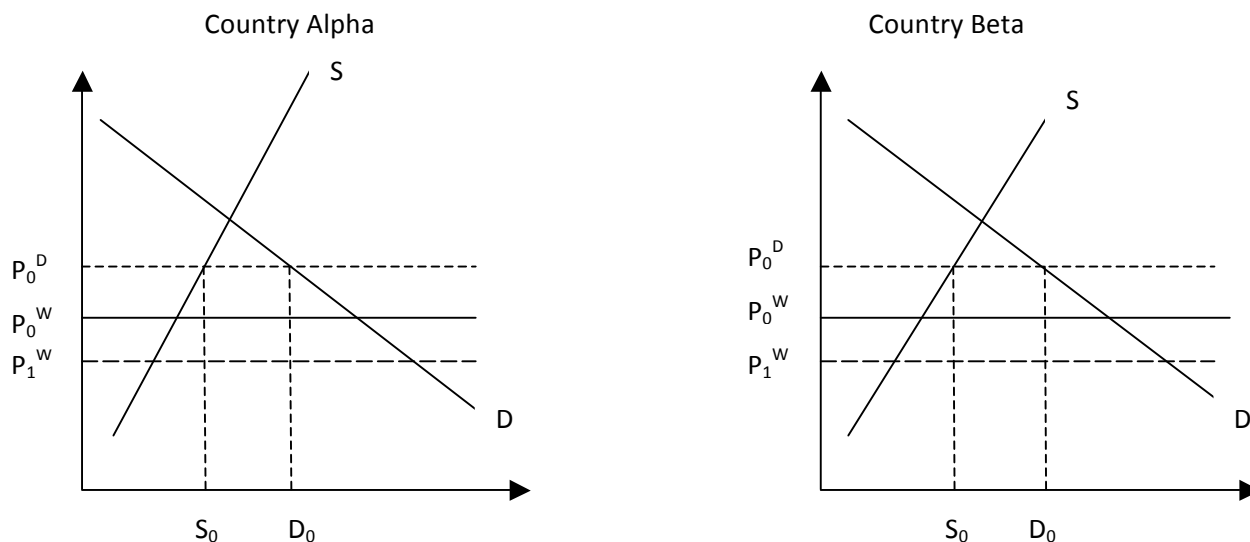
**International Trade Policy**  
**Midterm Exam**  
**October 29, 2012**

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 30 points.

**1. (5 points)** In the space below explain the Most Favored Nation principle. Include in your answer:

- a. What the MFN principle says and what it requires members of the WTO to do;
- b. What exceptions from MFN are permitted by the WTO;
- c. Why it is important for international trade relations and what is the reason for granting some exceptions.

2. (8 points) Imagine there are two almost identical small open economies, Country Alpha and Country Beta, whose markets for a good are shown below. Each faces the same initial world price for the good,  $P_0^W$ , and each is using a trade policy that causes the domestic price initially to be  $P_0^D$ , with quantities supplied and demanded,  $S_0$  and  $D_0$ . The one difference is that Country Alpha is using a specific tariff, while Country Beta is using a quota, with the import rights of the quota being licensed by the government through an auction, and going to the highest bidder.



a. How, if at all, do levels of initial welfare in these two countries (of suppliers, demanders, and government) differ, and why?

b. Now suppose that, for both countries, the world price of the good falls from  $P_0^W$  to  $P_1^W$ , and that each country keeps its particular trade policy in place at the same size as before. Show in the two figures above the values after the world price change of domestic price,  $P_1^D$ , supply,  $S_1$ , and demand,  $D_1$ .

c. Say in words and indicate also in the figures above, as appropriate, how the welfare of each of the constituencies (suppliers, demanders, and government) are affected by this fall in world price.

d. How would your answers to part (a) have been different if Alpha had been a large country? And if Beta had been a large country as well?

- 3.** (6 points) Georgia is a small country, and its potential trade partners are the EU and Russia. The government of Georgia must decide whether to sign a free trade agreement (FTA) with the EU.
- a. Using a partial equilibrium approach showing a representative import market for Georgia, illustrate under which conditions the FTA between Georgia and the EU will be welfare-improving for Georgia, carefully explaining welfare effects in your diagram.

b. Using the same type of diagram, show under which conditions instead the Georgian government should NOT sign the agreement with the EU, carefully explaining your diagram.

c. (2 points extra credit) Considering now Georgia's exporting industries, will there be an unambiguous gain in those sectors because of the FTA?

4. (5 points) “*We generally expect to observe higher tariffs in final consumption goods’ sectors and lower tariffs on inputs and intermediate goods sectors*”. Discuss this statement using the arguments of political economy of protectionism, explaining which groups will gain and lose because of the tariffs in the different types of sectors, and the possible differences in their lobbying power.



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