Review Questions for Midterm #1

1. Without trade countries must consume what they produce - country’s production possibilities frontier (PPF) and consumer possibilities frontier (CPF) are the same line. With trade the theory of comparative advantage indicates a country can specialize and trade for what it doesn’t produce itself. This allows a country to consume above it’s production possibilities frontier (i.e. the CPF is above the PPF). Explain why this is possible. Use graph(s) as part of your answer.

2. The Ricardian Comparative Advantage assumes that labor is the only production input and thus differences in labor productivity is the main driver of the model dynamics. Do you think this diminishes the usefulness of the model in describing modern trade patterns? If so why, if not why not? Given current trends in production and technology, is the model becoming even more/less relevant?

3. Where do the gains from trade come from in the comparative advantage set of theories? Where do the gains from trade come from the Monopolistic Competition Model come from?

4. A foundation for Modern trade theory is the theory of Comparative advantage. i) given that some countries are more efficient at producing almost all the goods they consume compared to other countries (say Western countries compared to sub-Saharan countries in Africa) how does comparative advantage explain the reasons such countries trade with each other? ii) given that industries become more efficient at production over time, how would this change your answer in part i)?

5. Another foundation of Modern trade theory indicates that scale economies is a major factor in describing trade between countries. Using a major manufacturing industry as an example (e.g., automobiles) describe how scale economies explains patterns of trade and what benefits come from this type of trade.

6. The overall concept of comparative advantage, whether using the Ricardian or HOV models, is largely a static concept. As such, theories such as Factor Price Equalization, often fail when tested on country trade data. However, economists argue that a dynamic test of trade models (i.e., trade over time) would tell a different story in many cases. Discuss. Can you think of any examples where, say, Factor Price Equalization fails static tests but looks much better in a dynamic framework?

7. Strategic interaction is a key assumption for most models of oligopolistic market structure. This is not the case, however, for the Monopolistic Competition model. Why might this be considered both a strength and a weakness of the model? What is the main strength of the model?

8. If one country's wage level is very high relative to the other's (i.e., \( \frac{w_1}{w_2} > \frac{a_2}{a_1} \) where \( w_1, w_2, a_1 \), and \( a_2 \) are the wages and labor productivity in countries 1 and 2 respectively so Country 1’s relative wage exceeds the relative productivity ratio), and if they both use the same currency, does comparative advantage still provide a theoretical motivation for trade? Can anything be said about who gains the most from trade?

Although the gravity model was not discussed in class, be familiar with it for possible exam questions.

The exam will be close book, closed notes. No extra paper will be needed, just a pen/pencil and calculator if you wish.

Be able to duplicate and discuss all the graphs used in class to illustrate concepts.

There will be (a) question(s) on the articles discussed at the beginning of each lecture and posted on the class webpage. You should know the main points from each.