

Study Questions
(*with Answers*)

Lecture 4
Modern Theories and
Additional Effects of Trade

Part 1: Multiple Choice

Select the **best** answer of those given.

1. Which of the following is **not** a possible cause of a country having a comparative advantage in a particular good?
 - a. Low demand for the good.
 - b. Relative abundance of the factor of production used intensively in producing the good.
 - c. A superior technology for producing the good.
 - d. An unusually large number of firms producing the good.
 - e. Relative scarcity of the factor of production that is not used intensively in producing the good.

Ans: *d*

2. Which of the following is **not** normally regarded as a factor of production?
 - a. Human Capital
 - b. Land
 - c. Money
 - d. Labor
 - e. Capital

Ans: *c*

3. The presence of increasing returns to scale in an industry tends to
- a. Make that industry perfectly competitive.
 - b. Discourage producers from exporting.
 - c. Give a comparative advantage in that industry to large countries.
 - d. Cause price in that industry to rise with output.
 - e. Reduce industry costs the larger is the number of firms competing.

Ans: c

4. According to the factor proportions model, countries have comparative advantage in the good that
- a. Employs a relatively large amount of their scarce factor.
 - b. Employs a relatively large amount of the factor that they have relatively more of than other countries.
 - c. Uses intensively their scarce factor.
 - d. Requires proportionately more of every factor than the goods they import.
 - e. Increases their proportional endowment of their scarce factor.

Ans: b

5. Factor Price Equalization means that,
- a. All workers are equally productive.
 - b. If a country fails to trade, its skilled workers will earn no more than its unskilled workers.
 - c. Trade causes the return to human capital to be the same as the return to physical capital.
 - d. For countries to trade freely, they must tax factors of production so that firms in all countries pay the same factor prices.
 - e. Free trade causes identical factors in different countries to be paid more nearly the same than they were in autarky.

Ans: e

6. Table 1 of Bivens, “Globalization and American Wages,” shows calculated effects of globalization on incomes of US middle-income households in 1995 and 2006. Why is the effect in 2006 so much larger than in 1995?
- a. Because the share of less developed countries in trade was larger in 2006 than in 1995.
 - b. Because US tariffs were much lower in 2006 than in 1995.
 - c. Because many countries ceased buying US exports after the 1997 Asian Financial Crisis.
 - d. Because countries in Europe adopted a common currency (the euro) in 1999.
 - e. Because the ability of US labor unions to resist globalization was undermined by the Bush administration.

Ans: a

7. Which of the following is one of the implications of the New Trade Theory?
- a. Countries as a whole must gain from trade.
 - b. A country can only hurt itself by using government policies to promote exports.
 - c. Consumers gain from the increased variety of goods that trade makes available.
 - d. A country may export a good or import it, but not both.
 - e. A tariff to protect an industry in a small country hurts demanders more than it helps suppliers.

Ans: c

8. Which of the following best captures Krugman’s view of the lesson of the New Trade Theory for trade policy, according to his article “Is Free Trade Passé”?
- a. Countries are almost certain to lose from trade unless their governments intervene.
 - b. Countries may lose from trade, and are likely to lose if their governments pursue a policy of free trade.
 - c. Countries may gain or lose from trade, and it does not much matter what the government does.
 - d. Countries will most likely gain from trade, and in any case they are not likely to do better if their governments intervene.
 - e. Countries necessarily gain from trade, and government intervention can only make matters worse.

Ans: d

9. Which of the following is a distinctive implication of the New New Trade Theory (i.e., the Melitz Model), not present in the New Trade Theory?
- a. Trade increases average productivity as more productive firms expand to export.
 - b. Consumers gain from the increased variety of goods that trade makes available.
 - c. Trade encourages research and development and thus the creation of new products.
 - d. A country may both export and import the goods from the same industry.
 - e. A tariff to protect an industry in a small country hurts demanders more than it helps suppliers.

Ans: a

Part II: Short Answer

Answer in the space provided.

1. Indicate, by circling the correct answer, what the Heckscher-Ohlin model predicts about the changes that will occur when a country opens up to international trade.

- a. Production of its export good will:

expand contract stay the same *Ans: expand*

- b. Production of its import-competing good will:

expand contract stay the same *Ans: contract*

- c. Demand for the country's abundant factor (at initial factor prices) will

increase decrease stay the same *Ans: increase*

- d. The price of the scarce factor will

rise fall stay the same *Ans: fall*

- e. The price of the abundant factor will

rise fall stay the same *Ans: rise*

2. Demands for factors are sometimes said to be “derived demands”. What are they derived from?

Ans: Factor demands are derived from the demands for the outputs that they are used to produce.

3. According to the Stolper-Samuelson Theorem (circle the correct answers):

- a. Free trade benefits the [scarce / abundant] (*Ans: abundant*) factor and hurts the [scarce / abundant] (*Ans: scarce*) factor.
- b. A rise in the price of a good raises the real income of the factor that [is / is not] (*Ans: is*) used intensively in its production and lowers the real income of the factor that [is / is not] (*Ans: is not*) used intensively in its production.

4. The two statements in question 3 are actually equivalent because, in the HO model (circle the correct answers):

- a. Free trade raises the relative price, within the country, of the country's [export / import] (*Ans: export*) good and lowers the relative domestic price of its [export / import] (*Ans: import*) good.
- b. A country will export the good that uses its [scarce / abundant] (*Ans: abundant*) factor intensively in its production and import the good that uses its [scarce / abundant] (*Ans: scarce*) factor intensively in its production.

5. From the list below, select the **three** (3) assumptions that were introduced by the New Trade Theory and that were not made in previous trade models:

- ☒ Product differentiation
- ☐ Factor proportions that differ across industries
- ☒ Imperfect competition
- ☐ Firms in an industry are heterogeneous
- ☐ Differences in unit labor requirements
- ☐ Tariffs
- ☒ Increasing returns to scale
- ☐ Constant returns to scale

6. Answer each of the questions below in the space provided, with a sentence or less (e.g., "Because..."):

- a. Why does the presence of imperfect competition create an additional opportunity for a country to gain from trade that would not exist if all markets were perfectly competitive?

Ans: Because trade forces domestic firms to compete with foreign firms, increasing the degree of competition, and reducing the distortions caused by imperfectly competitive firms.

- b. How can the existence of some industries with increasing returns to scale and other industries with decreasing returns to scale cause a country to lose from trade?

Ans: Because a small country will then have a comparative advantage in decreasing-returns sectors, and when it expands in order to export, its productivity will go down.

- c. How does the existence of industries with increasing returns to scale create an additional opportunity for the world to gain from trade?

Ans: Because by specializing in a smaller number of industries, countries can produce more in each, and the costs of production will therefore fall.

7. Define the following terms:

- a. Autarky *Ans: The situation in which a country does not engage in international trade; self-sufficiency.*

- b. Intra-firm trade *Ans: Exports and imports that take place within a firm, such as sales by a foreign subsidiary back to the parent company.*

- c. Scarce factor *Ans: A factor that a country has less of, compared to other countries, than it has of other factors; a factor that is relatively high-priced in autarky.*

- d. Capital intensive industry *Ans: An industry that uses relatively more capital than other industries; an industry that employs a higher ratio of capital to other factors than is employed in other industries.*
- e. Intra-industry trade *Ans: Export and import within the same industry.*

- f. Strategic trade policy *Ans: The view that government policy can tilt the terms of oligopolistic competition to shift excess returns from foreign to domestic firms.*
- g. Increasing returns to scale *Ans: The property that output rises more than in proportion to inputs when all inputs are expanded in the same proportion.*