

**Economics 165**  
**FINAL EXAM**

This is a three hour exam. Please make sure to provide both analytical support and economic intuition for your answers. You should spend the first ten minutes reading the exam. Good luck!

**Part I:** (50 points) Answer **two** of the following three questions.

1. The newspapers have been filled recently with stories of unsafe products (e.g., lead-tainted Barbie Dolls) being exported from China. Suppose that consumers throughout the world (i.e., all consumers in the world) respond to this news by reducing their expenditure shares on goods currently produced in China. Using the Continuum-of-Goods Ricardian Trade Model, with the home country representing “China” and the foreign country representing “the rest of the world,” determine what impact this shift in expenditure shares will have on Chinese competitiveness in the world economy.
2. We saw in class that, when goods prices are fixed in the short run, an unexpected permanent increase in the U.S. money supply leads to an “overshooting” of the spot exchange rate in the short run. Now suppose instead that, with goods prices fixed in the short run, there is an unexpected permanent increase in the foreign (“British”) money supply. Would the exchange rate still “overshoot” in the short run? Note: in answering this question, you may assume that output is exogenously fixed in the short run and the long run.
3. True/False Explain: Consider the 2-good 2-country Ricardian Trade Model. Suppose in the free-trade equilibrium, country A is producing both goods while country B is specialized in the production of good  $y$ . If free labor migration is now allowed between the two countries so that all workers are free to migrate in search of the highest wage, and if *any* workers choose to leave country B and migrate to country A, then *all* of country B’s workers will choose to leave country B and migrate to country A.

**Part II:** (40 points)

Consider a country, say country A, that is “large” in world markets (i.e., country A can impact its terms-of-trade with its tariff choice). Suppose that the government of country A has made its tariff choice unilaterally (i.e., in the absence of a trade agreement). From this starting point, we saw in class how the government of country A could always benefit – according to its own objectives – from reciprocal tariff liberalization with another (large) country that allows country A to reduce its tariff without impacting its terms-of-trade. However, this does not mean that every citizen within country A will benefit from the reciprocal tariff liberalization.

Assuming that the citizens of country A are motivated by their own real factor incomes, use the Specific Factors Model to determine who within country A would be expected to support the government in its decision to engage in reciprocal tariff liberalization, and who within country A would be expected to oppose the government’s decision.

As discussed in class, the Specific Factors Model is most appropriate for assessing short-run impacts, and so implicit in our use of the Specific Factors Model just above is the assumption that the citizens of country A are focused on the short run when they decide whether to support or oppose their government’s reciprocal trade liberalization. Of course, it is possible that the citizens of country A adopt a long-run perspective when evaluating the pros and cons of reciprocal trade liberalization. Assuming then that the citizens of country A are motivated by their own real factor incomes and are focused on the long run, use the Heckscher-Ohlin Model to determine who within country A would be expected to support the government in its decision to engage in reciprocal tariff liberalization, and who within country A would be expected to oppose the government’s decision. You may assume here that country A is capital abundant and that the trade-pattern predictions of the Heckscher-Ohlin Model hold.

**Part III:** (10 points)

Last Friday, the U.S. dollar reached an all-time low against the Euro. Suppose that Ben Bernanke decides that he must do something temporarily to the U.S. money supply so that the dollar appreciates relative to the Euro in the short run. Using the AA-DD model covered in class, answer the following questions:

(a) In which direction should the U.S. money supply be temporarily adjusted to achieve the desired effect on the dollar/Euro spot exchange rate ( $s$ ) in the short run? What implications will this temporary change in the U.S. money supply have for the level of U.S. output ( $Y$ ) and the domestic current account balance ( $CA$ ) in the short run?

(b) Now suppose that the U.S. fiscal policy authorities want to work in tandem with Bernanke and temporarily adjust government spending ( $G$ ) so as to hold  $Y$  fixed in the short run. In which direction should  $G$  be temporarily adjusted so that, in combination with Bernanke’s temporary money supply change,  $Y$  is left unaffected? Will the implied change in  $G$  enhance or frustrate Bernanke’s goal of appreciating the dollar against the Euro in the short run?