**EXAMINATION**

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| **Course code:**  SFB11615 | **Course:**  International Economics |
| **Date:**  May 14, 2019 | **Duration:**  09:00 – 13:00 (4 hours) |
| **Permitted sources:**  English – mother tongue dictionary  Mother tongue – English dictionary  Calculator | **Lecturer:**  Roswitha M. King |
| **The examination:**  The examination papers consist of 4 pages inclusive this page. Please check that the examination papers are complete before you start answering the questions.  The exam consists of 4 (four) exercises. You must solve all four exercises. The exercises have equal weight.  The numbers in square brackets indicate the maximum number of ‘points’ obtainable for exercises and sub-exercises. | |
| **Date of announcement of the examination results**: June 4, 2019  Examination results will be available in Studentweb. | |

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*Show all your solution steps. Interpret the meaning of your results. Explain all symbols that are not already explained in the given text. If graphing is involved, be sure to label the axes and all elements in the graph. If formulas are involved, first work with the general formula, then later fill in numbers. Clearly indicate what your final answer is. Give opening and concluding statement. Good luck!*

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1. [25%] **Absolute- and Comparative Advantage**

Assuming the usual Ricardian conditions with their linear production possibilities frontier we consider two countries, Portugal and England. Initially both countries are proud to be self-sufficient and both produce wine and cloth using one factor of production, labor. The production relations are as follows:

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| --- | --- | --- |
|  | Labor input (in hours) per unit of wine | Labor input (in hours) per unit of cloth |
| Portugal | 80 | 90 |
| England | 120 | 100 |

a) [5] Putting wine on the horizontal axis and cloth on the vertical axis, graph each country’s

production possibilities frontier labelling all important points and lines.

b) [5] Showing your calculations and your reasoning, explain which country has an **absolute**

advantage

1. In wine
2. In cloth

c) [6] Showing your calculations and your reasoning, explain which country has a **comparative**

advantage

1. In wine
2. In cloth

d) [9] Now it so happens that the two governments have economic advisors who tell them about the gains from opening up trade between the two countries and the heads of state believe them and open up their countries for trade. Let us assume that in this new international market 1 unit of wine exchanges for 1 unit of cloth.

(i) Which products does Portugal export and import?

(ii) Which products does England export and import?

(iii) Is it advantageous or not for Portugal to engage in export and import? Explain in detail why it is or is not.

(iv) Is it advantageous or not for England to engage in export and import? Explain in detail why it is or is not.

(v) What exactly do we mean by the *gains from trade* here? Explain in detail.

**2.** [25%] **International Trade and Increasing Marginal Cost of Production**

This exercise explores the theory of international trade under the assumption of increasing marginal costs of production (bowed-out production possibilities curve). We consider trade in wheat ,*W*, and cloth , *C*. The graphs, below, show production possibilities curves for the USA (United States) and for the Rest-of-the-World (ROW), as well as indifference curves. In this way we are looking at both the production side (production possibilities curve) and the consumption side (indifference curves). The Indifference curves are labelled *I1*and *I2*. The point S0 indicates each country’s production of wheat and cloth BEFORE trade opens up.



*Your task is as follows:*

Explain the meaning of the graph in detail. Imagine you are explaining this to someone who has never taken an economics course before. Explain the meaning of all the curves, lines, point, and symbols, and tell the story about what international trade does to the USA and ROW. The story should include a part that explains about the countries in autarky (before trade opens up) and a part about the countries after trade opens up between them. The story should include quantities and relative prices. The story should include imports and exports and an explanation of the gains from trade. It is important that the explanations specifically refer to the graphs and the details given in it.

3. [25%] **Effect of Changes in Relative World Prices on Production and Consumption**

**in the Stndard Trade Model.**

Here we consider two food producing countries, country B and country C. They are

trading partners. Country B produces beans. Some of the beans are consumed in country

B and some are exported to country C. Country C produces corn. Some of the corn is

consumed in country C and some is exported to country B. So, consumers in both

countries consume both products. Consumers in both countries have identical tastes and

preferences for the two products. Both countries are small and they take relative world prices as

given. In the framework of the ‘standard trade model’ explain the following:

1. [12,5] There occurs a change in relative world prices. The relative price of beans increases. How will this affect production of beans in the bean-producing Country B?
2. [12,5] We now assume that the *income effect,* associated with the increase in the relative price of beans, is greater than the *substitution effect*. Under this assumption, what will be the effect of the increase in the relative price of beans on the consumption of beans in the bean-producing Country B?

**4.** [25%] **Internal- and External Economies of Scale and International Trade**

a) [6] Explain the concept of *Internal Economies of Scale.*

b) [6] Suppose we have a firm that is operating under conditions of internal economies of scale. The

firm originally has one production site. Then we observe that this firm is opening up a second

production site for manufacturing the same product. Is that not a bad idea, given that the firm

enjoys internal economies of scale? Explain why or why not this is a bad idea.

c) [6] Explain the concept of *External Economies of Scale*.

d) [7]Why are *Internal*- and *External Economies of Scale* of interest in the context of International

Trade. Explain.

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