

ECON 3224 International Economics
Problem Set 2: 9th March 2009

Instructions: You need to solve the PS and turn it in by the **18th March (Wed)**. You can hand it put it in my mailbox (ECON office, Professional Building) **before 5pm.**

QUESTION 1 (SCANTRON) Choose the **correct** statement.

- a) The policy bias towards trade barriers (in the US) arises because politicians are not concerned at all about consumer welfare.
- b) A basic role of multilateral trade commitments is to restrain policy-makers from using aggressive trade policy.
- c) One reason for growth in the use of VERs is that they are simpler to administer than tariffs.
- d) The rents created by an import quota go to the domestic government.
- e) (blank option – don't choose).

QUESTIONS 2 to 7 are all interconnected and share the same information, which is given in the diagram on the next page. The diagram shows the supply and demand situation for a specific good in a country called Erewhon.

For all of these questions, world price is 16.

(Note: In the answers to the questions, the sizes of certain areas are indicated by the letters placed on the diagram. For example, “A” indicates the area of the rectangle in which A is placed, “E” indicates the area of the triangle in which E is placed, etc. Areas consisting of several parts are indicated by sums of the letters in the relevant parts.)

QUESTION 2 (SCANTRON) If Erewhon were in autarky, what would price be?

- a) 6.
- b) 10.
- c) 14.
- d) 16.
- e) 18.

QUESTION 3 (SCANTRON) Erewhon has a subsidy of \$2 that will be paid by the government on each unit of any good crossing its borders. (That is the tax is applied to both exports and imports, but not to goods that do not cross borders.) What is the domestic price in Erewhon?

- a) 6.
- b) 10.
- c) 14.
- d) 16.
- e) 18.

QUESTION 4 (SCANTRON) How many units of this good does Erewhon trade when it has the subsidy of 2 on all goods crossing its borders?

- a) 17
- b) 2
- c) 4
- d) 6
- e) 11

QUESTION 5 (SCANTRON) If Erewhon removes its subsidy of \$2 on all goods crossing the border and implements free trade what is the change in consumer surplus?

- a) G+H+J
- b) A+B+C+D
- c) G+H+J+X+Y
- d) A+B+C+D+G+H+J+X+Y
- e) X+Y

QUESTION 6 (SCANTRON) If Erewhon removes its subsidy of \$2 on all goods crossing the border and implements free trade what is the change in Producer surplus?

- a) $X+Y+Q+R+S+T+U+W+Z$
- b) $X+Y+Q+R+S+T+U+W$
- c) $G+H+J+K+L+M+N$
- d) $A+B+C+D+E+F$
- e) $X+Y$

QUESTION 7 (SCANTRON) If Erewhon removed its subsidy of 2 on all goods crossing its borders and implemented free trade, what would be the gain in national economic welfare?

- a) $S+T+L+M$.
- b) $Q+R+K+N+W+U$.
- c) $K+L+M+N$.
- d) $K+L+M+N+E+F$.
- e) $Y+Z$.

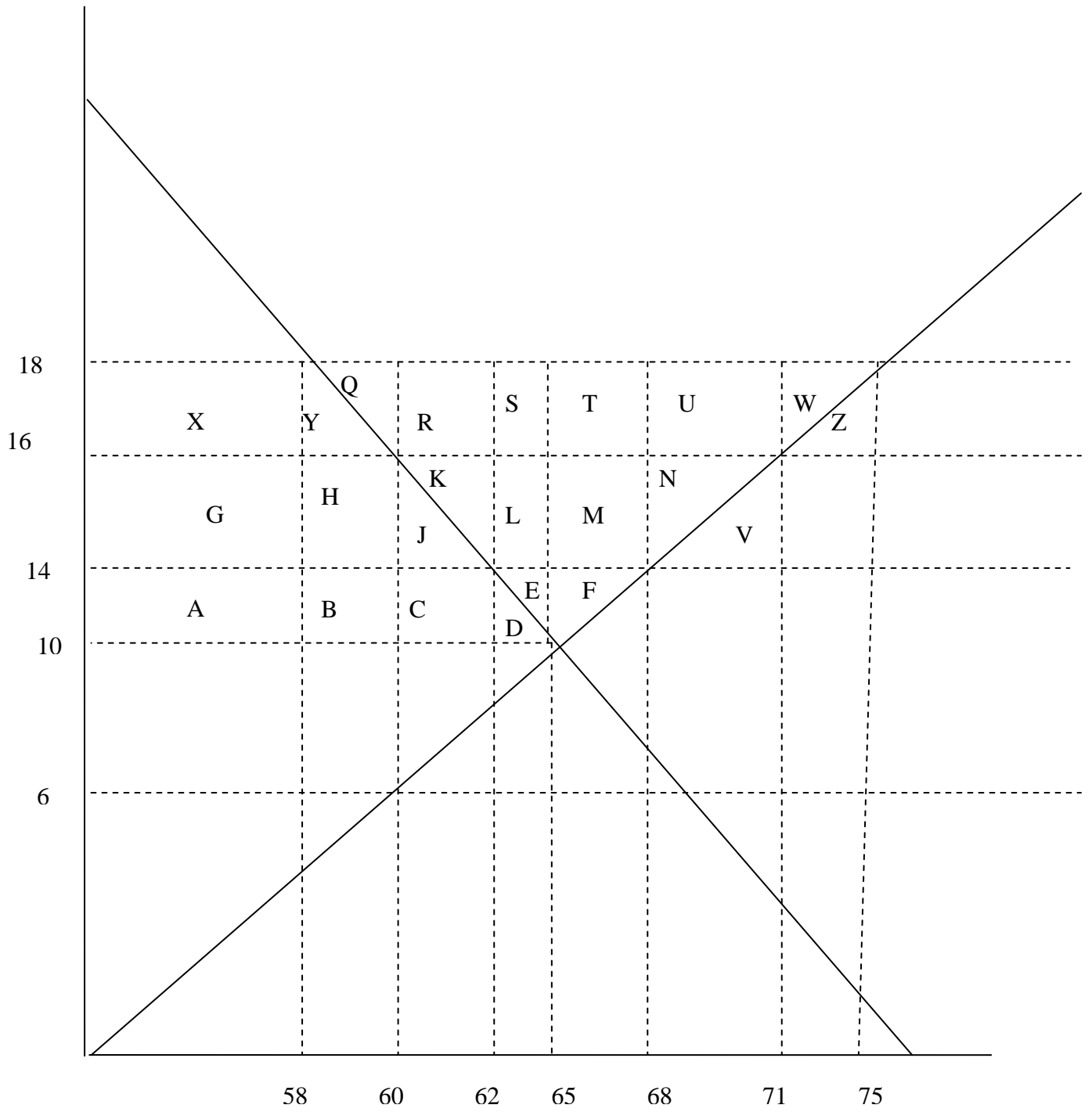


DIAGRAM FOR EREWHON

Problem 1. Consider a small country A. Let P be the price of cotton. The domestic demand for cotton in the country is given by $D^d=100-20*P$. The domestic supply curve is given by $S^d=20+20*P$. 16 points

- a. Draw the demand and supply curves of cotton. (Remember to put price on the vertical axis). 2 points.
- b. What is the autarky price, quantity produced and quantity consumed? Give numbers and indicate on the graph. 3 points
- c. Suppose that world price of cotton is \$4 per unit. Does this country export or import cotton? 1 point
- d. What is the free trade domestic price, quantity consumed & quantity produced of cotton? Give numbers and indicate on graph. 3 points
- e. Suppose the government gives a subsidy to cotton producers if they sell to the world. The amount of the subsidy is $s=\$0.5$ per unit. What happens to the domestic price of cotton— does it go up or down? 1 point
- f. What is the domestic consumption & production of cotton once the subsidy has been implemented? 2 points
- g. Using the methods that we used in class, very systematically show the welfare impact of the subsidy. First show the change in consumer surplus, then in producer surplus and then in government revenue. You may number any areas in the graph to illustrate your answer. 3 points
- h. What is the net effect on welfare? How can you show it on the graph? 1 point

Problem 2: Do problem 8 from Chapter 8. Note that I need all the answers in dollar amounts!

Problem 3: Do Problem 9, Chapter 8.

Note for above problems:

Remember to use the formula of area of a triangle = $.5*base*height$ in order to compute the answers

Suppose the question states “identify the net effect on this policy on the economy” that means that you need to compute the \$ amount of change in consumer & producer surplus, as well as government revenue (if applicable). If you do not compute the actual amounts then you will not receive any credit for the answer.