



HELSINKI UNIVERSITY OF TECHNOLOGY

## TU-91.2011 International Economics

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FINAL EXAM

October 2007

Name and student ID: \_\_\_\_\_

The year exercises were done: \_\_\_\_\_

**Answer on these question sheets and please, write clearly!!!!**

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1. The table below depicts the number of hours of labor required to produce one unit of cloth or one unit of wine in England and in Portugal. Which country has the absolute advantage in cloth and which in wine? And which country has the comparative advantage in cloth and which in wine? Justify your answers shortly.

(6p)

|       | England | Portugal |
|-------|---------|----------|
| Cloth | 100     | 90       |
| Wine  | 120     | 80       |

2. Japan can produce cars for \$12,000 each; the US can produce them for \$16,000, and Mexico can produce them for a cost of \$20,000 each. In the questions below you are asked about the effects on the Mexican economy of a free trade agreement with the United States. Assume that Mexican consumers will buy 1 million cars per year if the price is \$20,000 and that every \$1,000 drop in the price generates an additional purchase of 100,000 cars.
- a. Before the free trade agreement, Mexico had a tariff on cars equal to \$10,000 per car. What was the price of cars in Mexico before the FTA?  
(2p)
- b. Mexico signs the FTA with the United States but retains the tariff of \$10,000 on Japanese cars. What will the price of cars be in Mexico now?  
(2p)
- c. What is the amount of trade diversion and trade creation caused by the FTA? Show this graphically as well as numerically.  
(4p)
- d. What is the change in Mexico's economic welfare from the FTA agreement [e.g. in going from the situation in (a) to that in (b)]?  
(2p)
- e. Most customs unions or free trade agreements are created between countries of close geographical proximity. Why is this the case? Is this always welfare increasing? Why or why not?  
(4p)

3. What arguments can be given for protectionism? Which of these arguments are valid, and which invalid?

(8p)

4. Illustrate with help of a diagram, why many developing, agrarian countries think that, if the USA and EU would reduce/abandon their respective farm subsidies, it would improve their position.

(8p)

5. Will the law of one price (PPP) apply better to gold or Big Macs? Why?

(4p)

6. Read the article below and let it inspire you in answering the questions on the following pages:

## Dollar hits bottom, and then falls again

Bloomberg News, International Herald Tribune, Reuters, The Associated Press  
Published: September 21, 2007

The dollar fell sharply Friday, reaching a record low against the euro and capping a dramatic week for global financial markets that was marked by interest rate cuts, bank bailouts and skyrocketing oil prices.

The level of the dollar - often regarded as a barometer of the U.S. economy's health - dropped to \$1.4120 against the euro during business hours in Asia, reaching an all-time low for a second consecutive day. It also slipped against a number of other major currencies on speculation that the U.S. Federal Reserve would keep cutting interest rates as the world's largest economy weakens.

Sentiment soured for the dollar after Ben Bernanke, chairman of the Federal Reserve, stoked speculation that he might continue to lower rates following this week's aggressive trim of half a percentage point. Bernanke said Thursday that the sell-off in credit markets could make the housing recession more severe.

The dollar recovered somewhat during European trading, but investors believe that the currency will continue to lose ground, as it has for much of the past six years. "The dollar weakness will drag on," said Simon Derrick, chief currency strategist at Bank of New York Mellon in London. "The crisis is not over and the Fed is likely to cut rates further."

Officials across the globe, including the U.S. Treasury secretary, Henry Paulson Jr., have also been warning that it will take some time for the dust to clear from the fallout of the tanking U.S. real estate market. "The crisis isn't over," Peter Costello, the Australian treasurer, said Friday. "It still has some way to go." Banks as far away from the United States as Australia have taken a hit from the drying up of easy money that they need to do business. This week, depositors made a run on Northern Rock to withdraw their savings after the British bank revealed it was at risk of failing and needed a bailout from the Bank of England. The drama highlighted the severity of the shock waves stemming from rising defaults in U.S. subprime home mortgages: Northern Rock was not exposed to the subprime market but it did get tangled up in the ensuing credit crunch.

Among other superlatives that have gripped financial markets this week, the price of oil rose to a record of just under \$84 a barrel. The price could further threaten already slowing global growth. Gold also hit a 28-year high Friday as the dollar's slide prompted speculative investors to seek a safe haven.

The week also exposed some of the beneficiaries of the market turmoil. On Thursday, in a series of multibillion dollar deals, Dubai, Qatar and Abu Dhabi reached out to acquire significant stakes in three stock markets and a U.S. private equity firm, illustrating an increasing appetite for investing their growing wealth in high-quality assets abroad as oil prices hit records.

President Nicolas Sarkozy of France pressed Jean-Claude Trichet, president of the European Central Bank, to lower interest rates. "When the U.S. central bank lowers its rates, everything picks up; when we don't lower ours, we go down," Sarkozy said Thursday in an interview with the television stations TF1 and France 2. "I'm telling Mr. Trichet, 'Look at what others are doing.'"



Pressure is also growing on China, which European and U.S. officials say is keeping the yuan at an artificially low level to keep its exports strong. Finance Minister Christine Lagarde of France said Friday in Beijing that she was concerned about the impact not only of the euro-dollar rate but also the euro's rate against the Chinese yuan and the Japanese yen. She said she had raised the issue of unbalanced exchange rates both with Finance Minister Xie Xuren and Premier Wen Jiabao of China. She said there was a need for all countries affected by currency imbalances to think about how to engineer greater stability in financial markets.

The yuan has appreciated by a total of about 10 percent against the dollar since July 2005, when it was revalued and decoupled from a peg against the dollar to float in a managed range. But it has weakened against the euro by about 4.7 percent.

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a) Demonstrate the recent fall of dollar with demand-supply analysis. Explain your reasoning.  
(6p)

b) How can the rising value of the Euro and the slowing down of the American economy harm European countries?  
(4p)

c) If the ECB found the value of the Euro to be too strong, how could it try to devalue its value? Demonstrate your reasoning with an appropriate diagram.  
(6p)

- d) If the ECB does not lower interest rates – despite Sarkozy’s demands – what might be the reasons for the decision? What does the ECB hope to accomplish by not lowering (or even increasing) interest rates? Use appropriate diagrams to make your point.  
(8p)

EU-91-3011 International Economics

by Gerard Veronesi

FINAL EXAM

January 2007

Name and student ID: \_\_\_\_\_

The year of your birth: \_\_\_\_\_

Answer all three questions clearly and please write clearly. (30)

6. The 1998 budget deficit in the instance of France in 1998 is reported as the difference between the amount of € 100.4 billion and of € 100.0 billion. The two countries had the same rate of inflation in 1998. What is the real deficit? And which country has the comparative advantage in exports and which in imports? Justify your answer clearly.

|         | 1998  | 1999  |
|---------|-------|-------|
| Exports | 100.4 | 100.0 |
| Imports | 100.0 | 100.4 |

7. Discuss some of the pros and cons that will arise when two or more countries agree to form a common currency union.  
(6p)