

Study Questions (not to be handed in)

1. Define arbitrage and how it takes place. What happens to output and prices when international arbitrageurs move goods internationally?
2. Define opportunity costs and comparative advantage. How are they related?
3. What is a consumption possibilities frontier (CPF)? What is a production possibilities frontier (PPF)? When are they the same, and when are they different?

Referring specifically to the Ricardian Model...

4. How do I use information on technology and endowments to draw the PPF? What does the slope of the PPF tell me?
5. What equation determines the price of a good? What does it mean in words?
6. Under autarky, what equation determines the relative price of two goods in a country?
7. If I know autarky prices, how do I determine the pattern of specialization with free trade?
8. How do relative goods prices move as a result of arbitrage? i.e. how are free trade prices different from autarky prices? How does the answer depend on which country you are looking at?
9. What equation determines the wage in one country compared to the other? In words, what two factors determine this relative wage?
10. Why do countries gain from trade? How do I show how much each country will gain from trade?

Questions to be handed in

(Please....use plenty of paper, spread out your answers and write legibly.)

True/ False: For each question, answer True or False in the context of the Ricardian Model of trade. You don't need to explain your answer (but it would help you to understand why the question is true or false.)

1. Absolute advantage does not affect the level of wages in a country.
2. Closing relatively inefficient plants is necessary for a country to gain from trade.
3. A country must have an absolute advantage in a good to be a successful exporter of that good.
4. A country will not gain from trade if goods' prices after trade are equal to goods' prices in autarky.

Q. 5-16 Chile has a total supply of labor hours of 400 and Honduras has a total supply of labor hours of 200. The following table provides information on the unit-labor requirements in each country.

	Bananas	Apples
Honduras	10	40
Chile	4	2

In autarky...

5. Graph the PPF and CPF for Honduras and Chile. For each country, determine the opportunity cost of bananas in terms of apples (that is, how much banana production must be given up to produce apples).
6. Determine the relative price apples/bananas in both countries.
7. Which country has comparative advantage in producing apples? Which country has absolute advantage in producing bananas?

Allow these countries to trade...

8. Describe the pattern of trade. What happens to the composition of output in each country?
9. Provide a range for the relative price apples/bananas worldwide.
10. Suppose the relative price of apples/bananas under free trade is 1. What is the wage for Chile relative to the wage for Honduras?
11. At world prices apples/bananas = 1, could a firm paying Chilean wages to Honduran workers successfully export bananas to Chile?
12. Describe how the gains from trade depend on the terms of trade.

Start from the data in the exercise above. In each question 13-16 Honduras undergoes some change in its productive capacity. For each, redraw Honduras' original PPF and the new PPF for each change. Be sure to label the intersection points on the axes.

13. Honduras' labor endowment doubles.
 14. Labor becomes twice as productive in both apples and bananas.
 15. Honduras becomes twice as productive at producing bananas.
 16. Honduras becomes twice as productive at producing apples.
17. Of these four changes, which cause a change in Honduras' autarky prices?
 18. Of these four changes, which cause a change in Honduras' export good?

Wages in the US are \$25/ hour while wages in Mexico are \$5/hour.

Good	US unit labor requirement	Mexico unit labor requirement
Apples	1	2
Bananas	1	4
Cherries	1	5
Dates	1	6
Eggplant	1	10

19. Which goods will the US export? Which will Mexico export?
20. Suppose there is a tariff (tax) of \$6 on any good crossing the border in any direction. How does that change your answer to 19?