

101LON - The Economic Environment of Business

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Seminar 10

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1 Trade

1.1 Question 1

- Explain how absolute advantage and comparative advantage differ.
- Can two countries gain from trade if the opportunity cost ratios relating to production of goods they can both produce is the same? Explain.
- When does a country become an exporter of a good? An importer?

1.1.1 Answer

Definitions. Consider the discussion of advantages.

1.2 Question 2

Morgan and Oliver share a flat. They spend most of their time studying (of course), but they leave some time for their favourite activities: cooking pizza and making homebrew beer. Oliver takes 4 hours to produce 1 barrel of homebrew and 2 hours to make a pizza. Morgan takes 6 hours to brew 1 barrel of beer and 4 hours to make a pizza.

- a. What is each flatmate's opportunity cost of making a pizza? Who has the absolute advantage in making pizza? Who has the comparative advantage in making pizza?
- b. If Oliver and Morgan trade foods with each other, who will trade away pizza in exchange for homebrew?
- c. The price of pizza can be expressed in terms of barrels of homebrew. What is the highest price at which pizza can be traded that would make both flatmates better off? What is the lowest price? Explain.

1.2.1 Answer

Calculate the opportunity cost. Remember the difference between absolute and comparative advantage.

2 Open Economy

Please attempt to answer or solve all the following questions. If you require any assistance ask in class.

2.1 Question 1

- What is a trade deficit? Why is it important?
- Define net exports and net capital outflow. Explain how and why they are related.
- What is the exchange rate? Go online and find the exchange rates of dolar to GBP, euro to GBP and euro to dolar.
- What is the difference between the real and the nominal exchange rate?
- If a Japanese car is priced at 500 000 yen, a similar German car is priced at 10 000 euros, and a euro can buy 100 yen, what are the nominal and real exchange rates?

2.1.1 Answer

Definitions. Go online to find the exchange rates.

2.2 Question 2

- What do we mean with appreciation of a currency?
- What do we mean with depreciation of a currency?
- How can changes in the value of a currency affect the domestic economy?

2.2.1 Answer

Consider which part of the economy is affected by the value of a currency.

2.3 Question 3

- Suppose the French suddenly develop a strong taste for British wine. Answer the following questions in words and using a diagram.

- a. What happens to the demand for pounds in the market for foreign currency exchange?
- b. What happens to the value of pounds in the market for foreign currency exchange?

2.3.1 Answer

Why do we need foreign currency? Remember a currency behaves similar to any good in economics.

2.4 Question 4

- What are the main exchange rate regimes? Explain.

2.4.1 Answer

Definitions

3 MCQ

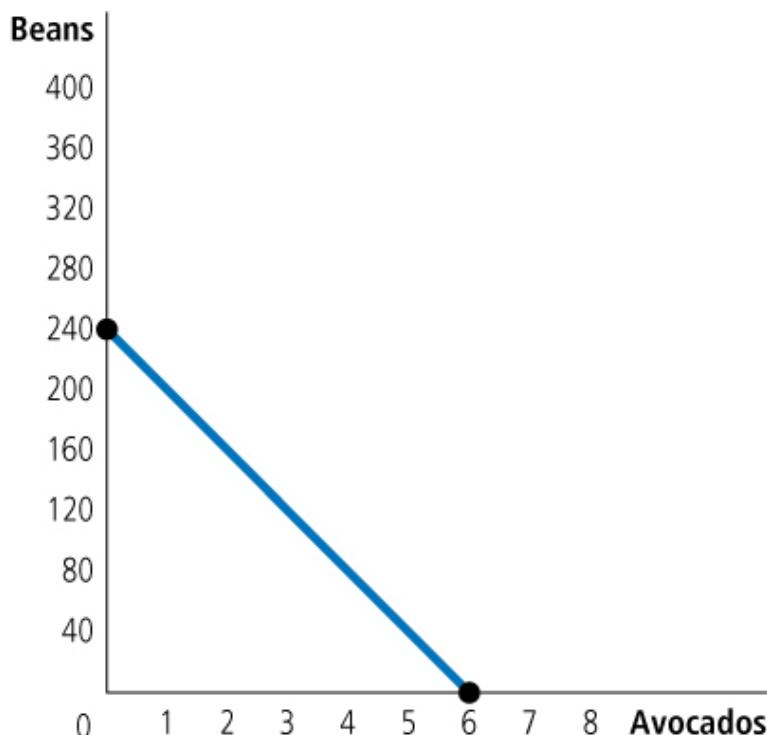
Read the questions carefully and choose ONE option only.

1. *Suppose the fictional country of Suria begins free trade in steel. As a result, Suria no longer produces steel. Since steel is used for guns and tanks, if there is a disruption in the supply of steel, Suria would not be able to defend itself in the event of a foreign conflict. In this case, and similar such cases, economists would argue that the national security argument would provide a legitimate reason for trade restrictions.*
 - a. True
 - b. False
2. *Suppose Jessica can wash six windows per hour or she can iron twelve shirts per hour. Peter can wash four windows per hour or he can iron ten shirts per hour. Which of the following is not true?*
 - a. Jessica has a comparative advantage over Peter in washing windows.
 - b. Jessica has an absolute advantage over Peter in washing windows.
 - c. Peter has an absolute advantage over Jessica in ironing shirts.
 - d. Peter has a comparative advantage over Jessica in ironing shirts.
3. *Refer to the Table. Assume that England and France each has 40 labor hours available. If each country divides its time equally between the production of cheese and wine, then total production is*
 - a. 40 units of cheese and 20 units of wine
 - b. 22.5 units of cheese and 14 units of wine
 - c. 45 units of cheese and 28 units of wine
 - d. 5 units of cheese and 8 units of wine

	Hours Needed to Make 1 Unit of		Number of Units Produced in 40 Hours	
	Cheese	Wine	Cheese	Wine
England	1	5	40	8
France	8	2	5	20

4. *Refer to the Figure. If the production possibilities frontier shown is for two months of production, then which of the following combinations of beans and avocados could Mexico produce in two months?*

- a. 2 avocados, 160 beans
- a. 1 avocado, 220 beans
- a. 3 avocados, 140 beans
- a. 5 avocados, 80 beans



5. *Suppose that a worker in Wheatville can grow either 50 bushels of wheat or 10 bushels of oats per year, and a worker in Oatland can grow either 25 bushels of wheat or 5 bushels of oats per year. There are 15 workers in Wheatville and 15 workers in Oatland. Which of the following statements is true?*

- a. Neither country could gain from trade with each other because Wheatville has an absolute advantage in both goods.
- b. Both countries could gain from trade with each other.
- c. Neither country could gain from trade with each other because neither one has a comparative advantage.
- d. Oatland could gain from trade between the two countries, but Wheatville definitely would lose.

6. *Refer to the Table. Which of the following combinations of cheese and wine could England not produce in 40 hours?*

- a. 15 units of cheese and 6 units of wine
- b. 5 units of cheese and 7 units of wine
- c. 25 units of cheese and 3 units of wine
- d. 40 units of cheese and 0 units of wine

	Hours Needed to Make 1 Unit of		Number of Units Produced in 40 Hours	
	Cheese	Wine	Cheese	Wine
England	1	5	40	8
France	8	2	5	20

7. *Luke and Carol are two toymakers who both produce trains and cars. In one month, Luke can produce 5 trains or 20 cars, whereas Carol can produce 8 trains or 24 cars. Given this, we know that*

- a. Luke has an absolute advantage in trains.
- b. Carol has an absolute advantage in cars.
- c. Luke has a comparative advantage in trains.
- d. Carol has a comparative advantage in cars.

8. *The nominal exchange rate is 12 South African rand, 600 Chilean pesos, 7 Croatian kuna, or 60 Indian rupees per U.S. dollar. A fast food breakfast costs \$5 in the U.S., 36 rand in South Africa, 3,000 pesos in Chile, 28 kuna in Croatia, or 240 rupees in India. According to these numbers, where is the real exchange rate between American and foreign goods the highest?*

- a. South Africa
- b. Croatia
- c. Chile
- d. India

9. *Dmitri, a Canadian resident, buys \$10,000 worth of olives from Cyprus. By itself this purchase*

- increases Canadian imports by \$10,000 and increases Canadian net exports by \$10,000.
- increases Canadian exports by \$10,000 and increases Canadian net exports by \$10,000.
- increases Canadian imports by \$10,000 and decreases Canadian net exports by \$10,000.
- increases Canadian exports by \$10,000 and decreases Canadian net exports by \$10,000.

10. *Arbitrage may not eliminate a price difference for a haircut in Paris versus a haircut in New York because*

- international travel would be too costly.
- it is not easy to get information on prices.
- there are different currencies.
- arbitrage can always occur.

11. *A country buys more from foreign countries than it sells to them. It has*

- a trade surplus and positive net exports.
- a trade deficit and positive net exports.
- a trade surplus and negative net exports.
- a trade deficit and negative net exports.

12. *Suppose the exchange rate rises. All else equal, which of the following could cause this in the open-economy macroeconomic model?*

- demand for net exports staying the same.
- an increase in the demand for net exports
- a decrease in the demand for net exports
- this situation is predicted by the model to never occur

13. *Suppose foreign citizens want to buy more U.S. goods and services at every given exchange rate. This*

- will shift the demand for dollars in the market for foreign currency exchange to the right
- will shift the demand for dollars in the market for foreign currency exchange to the left
- will have no effect on the demand for dollars in the market for foreign currency exchange
- cannot technically occur in industrialized countries.

14. *What could cause U.S. goods to become less attractive to consumers in the U.S. and abroad?*

- when the U.S. real exchange rate increases.
- when the U.S. real exchange rate decreases.
- when the U.S. real exchange rate stays the same.
- never.

15. *A policy that directly influences the quantity of goods and services that a country imports or exports is known as a*

- monetary policy
- defense policy
- trade policy
- there is no special name for this type of policy.