Chapter 1: Introduction

"U.S. and Trade Partners Maintain Unhealthy Long-Term Relationship"
By Louis Uchitelle, New York Times, Saturday, September 18, 2004

1. The subject of this article centers on the current account balance. Does this seem like an "international trade" or an "international money" issue?

Answer: Aspects of the issue seem to overlap with both areas of international economics. The article discusses goods and services transactions [trade], as well as international borrowing and exchange rates [money].

2. Many economists seem to be giving the issue of the current account a lot of thought. Does there seem to be a consensus in the article? Does your answer surprise you?

Answers will vary. If anything, the consensus is confusion—confusion at how the deficit has persisted for so long with no severe consequences. Bergsten stands out as the most alarmed, though almost every economist seems a bit concerned about the trade deficit. This economist, on the contrary, is not concerned at all about the current account deficit, and you may come to your own conclusion upon reading further chapters. In general economists tend to agree about many big-picture issues, but may disagree occasionally where the data is open to interpretation or when more ideological considerations come into play.

3. Near the end of the article there is a logical fallacy about the current account deficit. Can you find it?

Answer: The 4th to last paragraph begins with the sentence "[w]ith less and less production at home…" This sentence is fallacious because the current account does not imply that less production is taking place at home—in fact GDP has been rising steadily year after year, even while the U.S. runs a large trade deficit—it implies that consumption taking place at home exceeds production at home. The current account balance is a statement about the level of production relative to the level of consumption, not about the absolute level of production. Be wary, you can't always believe what you read!
Chapter 2: World Trade: An Overview

"China in Africa: All Trade, With No Political Baggage"
By Howard W. French, New York Times, Sunday, August 8, 2004

1. The article describes Africa as "a mere footnote" in the global trading system due to the extremely low volume of trade going in and out of the continent. Is this consistent with the gravity model?

Answer: Quite. One of the predictions of the gravity equation is that trade will be proportional to income. As many African countries are among the poorest in the world, we would not expect much international trade to occur there.

2. "Forty African countries have trade agreements with China now." Why do trade agreements create an anomaly with respect to the basic relationships with income and distance in the gravity model? Hint: Think about why intranational trade is greater than international trade.

Answer: Administrative and legal barriers are substantial across national borders—thus the large effect of borders on the volume of trade. Trade agreements typically reduce import taxes and streamline administrative procedures for goods crossing borders. This is why both adjacent countries and countries with trade agreements experience more trade than would be predicted by only their incomes and proximity.

3. "China's trade with the African continent" has experienced a "50 percent increase" in recent years. Apart from the trade agreements mentioned above, how would you explain this increase?

Answer: Given that China and Africa have not become any closer geographically, it could be explained by the recent rapid economic growth in China. Higher Chinese income leads to an increased volume of trade, according to the gravity equation.

4. What sort of goods does China seem to be trading with its new African partners? How does this match up with historical features of the pattern of trade?

Answer: Oil seems to be the most important component of this new trade, with both Gabon and Sudan—though it is not clear from the article what China is trading in return. So called "primary products" such as agricultural goods and natural resources have been the most important component of trade in the past, so this new trade between China and Africa seems to closely match earlier days of the global trading system. In the past, primary products were exported by poorer countries in exchange for manufactured goods, so it is likely that China is sending semi-skilled manufactures back to Africa.
Chapter 3: Labor Productivity and Comparative Advantage: The Ricardian Model

"Food Imports Close to Matching Level of Exports, Report Says"
By Elizabeth Becker, New York Times, Wednesday, November 24, 2004

1. Do you find it surprising that the United States is about to become a net importer of food? Are you concerned?

Answer: Given the advanced technology and highly educated population of the U.S., it doesn't seem all that unusual that other countries might be comparatively more productive in the food sector—the opportunity cost of producing food should be quite high in the U.S. in terms of higher-technology goods we would have to forgo. Cheap imports are hardly cause for concern—they reveal our trading partners' comparative advantage, allowing the U.S. to reallocate resources to our sector of comparative advantage.

2. In the past, what do you think the source of U.S. comparative advantage in agriculture has been?

Answer: Answers will vary. Two possibilities come to mind. American farmers may have access to some of the most advanced agricultural and bio-technology in the world. Alternatively, U.S. comparative advantage may be more artificial because of "$16 billion in federal farm subsidies every year."

3. If America does indeed become a net importer of food, what could you conclude about the unit labor requirement in the agricultural sector relative to other parts of the economy (assume there is only one other industry)?

Answer: The ratio of the unit labor requirement for food and the unit labor requirement for the other sector of the economy must be higher in America than America's trading partners. This inequality yields a higher autarky opportunity cost for agricultural products in the United States. Alternatively, the ratio of labor productivity (the inverse of the unit labor requirement) in the agricultural sector to labor productivity in the rest of the economy must be lower in the U.S. than abroad.
Chapter 4: Resources, Comparative Advantage, and Income Distribution

Article 1:
"It's Not New Jobs. It's All the Jobs"
By Louis Uchitelle, New York Times, Sunday, August 29, 2004

1. Given your familiarity with the Heckscher-Ohlin model of trade, how would you interpret the assertion that "the incomes of most workers" in the US "are sinking"? If trade flows are growing, is it surprising?

Answer: In the context of increasing globalization, and viewed through the lens of the H-O model, this should not be surprising. The "Stolper-Samuelson effect" tells us that the prices of final goods correspond to the prices of the factors of production. So if imports are increasing—either due to reduced US trade barriers or improved production abroad—their prices must be lower, and the returns to the factors of production must be changing. Because free trade pushes resources toward the sector of comparative advantage, the returns to the scarce factor will be falling. In the educated, industrial United States the scarce factor is presumably raw labor. Hence it is unsurprising that the average American worker might be hurt by growing international trade.

2. Gross Domestic Product (GDP) has been growing in most quarters of the last few years as wages have simultaneously been falling. Is this consistent with the Heckscher-Ohlin model? Why does it make falling wages less of a concern?

Answer: This remains consistent with the H-O model. Free trade produces winners and losers. If the falling wages belong to the losers, then higher returns to capital and education must be accruing to the winners. The Heckscher-Ohlin model also predicts that free trade will also make the nation as a whole better off; in other words, the winners gain more than the losers, and GDP will rise. This makes falling wages less of a concern, because it represents only one part of the impact of trade on the economy, and the losers could at least in theory be compensated by the winners.

3. To alleviate the plight of workers, the article suggests that "a higher minimum wage would probably help" or "an expanded government role in providing health insurance, relieving employers of some of the rising cost." Trying to think like an economist, and not just a trade theorist, are you skeptical of these solutions?

Answer: You should be! Minimum wages are notorious for creating unemployment among the lowest income groups—many people a laid off to create a handful of jobs at higher wages. Healthcare is a more sophisticated issue; the effects will not be nearly as straightforward as the article claims. If the government provides more health insurance, it will have to pay for it with higher taxes, which could easily fall on the workers and businesses it is intended to help.
4. Imagine the US economy is a specific-factors model with skilled labor and unskilled labor being the fixed factors, and wages falling among unskilled workers. Compared to the suggestions of the previous question, how would you help unskilled workers?

Answer: Answers will vary. One possibility is to "transform" unskilled workers into skilled workers through education or job training.
Chapter 4: Resources, Comparative Advantage, and Income Distribution

Article 2:  
"Ford and G.M. Lose Ground to Imports"  
By Danny Hakim, New York Times, Thursday, November 4, 2004

1. Should one be concerned that Ford and General Motors are losing market share to importers?

Answer: Not necessarily. This may simply reflect the comparative advantage of Japanese and German manufacturers over American automakers. Under free trade, imports typically displace some domestic production, but this leads to lower prices and a welfare-improving reallocation of resources.

2. What might cause Japanese manufacturers to have a comparative advantage in the production of automobiles?

Answer: The Heckscher-Ohlin model tells us that comparative advantage is related to factor abundance. Whatever factor of production is used intensively in the production of autos, the Japanese must have a lot of it! More precisely, a large supply of a factor of production reduces its price in factor markets, encouraging firms to purchase it.

3. If cars are capital-intensive goods, what might you conclude about factor abundance in the United States?

Answer: This would imply that the United States is labor-abundant, or at the very least that its relative capital abundance is falling.

4. How does your previous answer relate to Leontief’s paradox?

Answer: This is similar to what Leontief found: that the United States tended to import capital-intensive goods and export labor-intensive goods. This was surprising because labor-abundance is thought to be the province of the poorest developing countries. One resolution to the paradox suggests that American labor is highly educated and skilled, so much so that the U.S. exports labor-intensive goods. So American comparative advantage is not due to an abundance of cheap raw labor, but to an abundance of modestly priced yet very efficient labor.
Chapter 5: The Standard Trade Model

"In China, Farmers' Labor Bears Too Much Fruit"
By Keith Bradsher, New York *Times*, Friday, September 17, 2004

1. What economic forces have led to the reduction in litchi prices?

Answer: Sometimes things are as simple as supply and demand. Here the culprit is an increase in supply, as "in the last few years, litchi production has soared beyond anyone's expectations." The more direct causes of the increase in production seem to be (a) initially high litchi prices, (b) rising incomes, and (c) a lack of alternative saving or investment vehicles for Chinese peasants.

2. How does this phenomenon fit into your understanding of the terms of trade and its relationship to welfare?

Answer: Given that litchis are an export good for the Chinese, increased production has caused a deterioration in the terms of trade—a decline in the price of exports relative to imports—which, all other things equal, makes China worse off. However, greater production generally means greater real wealth, and Bhagwati's immiserizing growth has been found to be rare in practice.

3. The article refers to this increase in production as "overproduction". Is there overproduction or could this growth be optimal and rational?

Answer: It's difficult to say. Responding to high prices by investment and increased production is the essence of market forces, so it is clearly rational on an individual basis. Whether it is rational or optimal on an aggregate basis depends on the size of the decline in the terms of trade. Because China can influence world prices, there is some unexploited market power in the litchi market that a tightly controlled national cartel could take advantage of—to the detriment of litchi consumers in China and around the world.

4. The article notes that "[t]he Chinese government has banned the planting of any more litchi trees, and banks have stopped lending to litchi farms." Is this sort of regulation really necessary?

Answer: Probably not. Prices are signals about scarcity, and the initial signals [high prices] that caused the increase in production will be countered by new signals [low prices] that will discourage production and investment. In fact, if Zhao Jiqing "sorrowfully pulled nearly three-quarters of the ripening fruit off his trees and destroyed it", banning the planting of litchi trees seems quite unnecessary. The major market failure here is the lack of a futures market for litchis, which the Chinese government could take a role in developing.
Chapter 6: Economies of Scale, Imperfect Competition, and International Trade

"Stepping Up the Pressure Against Piracy in China"
By Sabra Chartrand, New York Times, Monday, December 6, 2004

1. Why is piracy an issue that is relevant for intraindustry trade?

Answer: You've learned that the firms engaged in intraindustry trade have large fixed costs, and therefore declining average costs. Firms that have large fixed costs spend billions of dollars creating intellectual property, and it is precisely firms in these industries that are the target of piracy, "DVD's, CD's and digital games" and "clothing and prescription drugs." All these industries have high fixed costs and relatively low marginal costs.

2. How is piracy affecting international trade?

Answer: For one, it is raising administrative and border costs to nations attempting to stop the flow of counterfeit or pirated goods. The more subtle and nefarious effects of piracy are the undermining of intellectual property rights and reducing incentives for innovation. By counterfeiting goods and smuggling them into industrialized countries, Chinese pirates are making it more difficult for firms to recoup their substantial fixed cost investments. This will ultimately reduce the production and trade of these differentiated products.

3. Could the amount of piracy in China be related to the lack of price discrimination?

Answer: It's certainly possible. Because per capita income in China is so much lower than the industrialized world, the willingness to pay for luxuries such as CDs and DVDs would also be much lower in China. So the emergence of piracy in China may be due at least in part to the failure of rich country firms to sell the goods less expensively in the developing world. The reason that these intraindustry trading firms are not engaging in this price discrimination, of course, is because it would create arbitrage opportunities by selling the goods back to rich countries. The possibility of arbitrage rules out significant price discrimination, so there is something of a market failure here.

4. The president of the International Intellectual Property Alliance states that "[a] CD costs 15 cents to produce." If that is true then why do CDs cost upwards of 100 times that in retail markets?

Answer: This is another feature of monopolies or monopolistically competitive industries—firms charge a price greater than marginal cost because products are differentiated, and the higher price goes to paying the higher fixed costs related to product development.
Chapter 7: International Factor Movements

Article 1:
"What Unions Can Gain From Immigration"

1. Traditionally, why have unions been against immigration?

Answer: While immigration has beneficial effects for the aggregate economy, it does lower wages, which will lower income for people whose primary, or only, factor of production is labor.

2. Have unions become pro-immigration?

Answer: Not quite. They have become pro-amnesty, not pro-immigration. As the article states, while "the A.F.L.-C.I.O. supported…legal status for illegal immigrants who are already here, it did not want more immigration." The union still seems very aware of the wage effects of unions in that they believe "'Employers shouldn't be able to use these workers to make wage stagnant.'" This seems like a fine line to walk!

3. What will unions gain from amnesty?

Answer: The answer must be politics over economics. Given that the unions have been unable to get existing illegal immigrants to leave, it must seek other ways to increase wages. Unions gain bargaining ability with firms through monopoly power as the sole seller of labor—which they do not have while some potential workers are outside the unions. By bringing illegal workers into the fold, the union increases its bargaining clout. On an economy-wide basis, this increases the political clout of labor relative to capital, which is an end goal of labor unions.
Chapter 7: International Factor Movements

**Article 2:**
"Republicans Squaring Off Over Bush Plan on Immigration"
By David D. Kirkpatrick, New York Times, Thursday, January 27, 2005

1. Why is immigration policy such a controversial issue?

   Answer: Like international trade, immigration has distributional effects. In other words, immigration creates economic winners and losers.

2. Is there an economic case to be made for more liberal immigration policies, such as President Bush's "guest worker proposal" which "enables people to come into our country in a legal way to work for a period of time"?

   Answer: From the perspective of the U.S., there is a solid case to be made for allowing more immigration. Abstracting from national security issues, there will be an increase in aggregate welfare in the United States. Wages will fall, but the rents earned by other factor owners will rise more than the loss of labor income.

3. Is it surprising that so many Republicans are coming out in opposition to Bush's immigration plan?

   Answer: Answers will vary. This economist finds it a bit surprising. Republicans are traditionally thought of as the party of business and capital, and those constituencies will do very well with more labor at cheaper wages; because capital and labor are complementary, the returns to capital will rise. So the Republicans seem extremely concerned about a typically Democratic constituency: labor.

4. If passed, what impact will a guest worker plan in the U.S. have on Mexico?

   Answer: From a distributional standpoint the effects seem pretty positive: the exodus of labor from Mexico will increase wages from an initial level that is much lower than the United States. On the other hand, national output will fall, as well as the returns to factors that work with labor.
1. Both globally and domestically, who are the winners and losers from the end of textile quotas?

Answer: Much of the article is devoted to the distributional effects of the end of the quotas, so there are many clues here. American textile workers and manufacturers, especially those in North Carolina, stand to lose. Consumers and retailers in the U.S. are expected to save an estimated $6 billion, which is a substantial gain. Globally, the big winners look to be the largest developing countries, including China, India, Pakistan, and Brazil. The article also suggests that many of the poorest countries in the world will be losers, like Cambodia and Bangladesh.

2. Based on your answer to the previous question, who must hold the quota licenses under the existing system?

Answer: It must be foreigners, making the effect of the quota similar to a voluntary export restraint (VER). Given the distributional effects in the developing world, smaller poor countries like Cambodia and Bangladesh must enjoy privileged access to rich country markets, at the expense of larger producers, like China, whose quota rights must be small relative to their productive capacity.

3. What will be the aggregate welfare effect of the end of global trading restrictions on textiles for the United States?

Answer: Because the quota licenses are held by foreigners, the gains in consumer surplus will exceed the losses to producer surplus. Even in the case where the quota license is owned by a domestic firm, the terms of trade effect is not generally sufficient to justify intervention.

4. What does your answer to the previous question suggest about helping Kannapolis, NC residents who used to work at textile mills?

Answer: Because the increase in consumer surplus is greater in magnitude than the decrease in producer surplus, it is theoretically possible to compensate the losers and still leave everyone better off. Clearly the government is not yet doing this, as "[c]urrent trade adjustment assistance…was denounced by factory owners and union officials as too little and too difficult."
Chapter 9: The Political Economy of Trade Policy

**Article 1:**
"Bush Accuses Vietnam and China of Dumping Shrimp on U.S. Market"
By Elizabeth Becker, New York Times, Wednesday, July 7, 2004

1. This article is vague about what the aggregate welfare effects of the proposed shrimp duties will be. What do you think the effect will be on producer surplus (American shrimp producers), consumer surplus, and government revenue? What about aggregate social surplus? Hint: See table 9-3.

Answer: There is no reason to believe that this situation will be any different from the standard tariff analysis, so American shrimp producers gain, the government collects the anti-dumping import duties, and consumers lose due to the higher prices. As always, the gains that go to producers and the government are less than the losses to consumers—aggregate social surplus falls.

2. American shrimp producers have a clear incentive to lobby for the anti-dumping duties. However, the article makes no mention of consumer opposition to the tariffs. Why?

Answer: Even if consumers are aware of the higher prices, the will have difficulty overcoming the problem of collective action, which is Olson's theory that large groups will have difficulty acting in their collective interest. Thus we expect the smaller group (American shrimp producers) to be more vocal, and therefore more successful in the political arena.

3. Because "imports…were driving down the price," Bradford Warner (representing the Southern Shrimp Alliance) states that, "It's very important for coastal communities from Texas all around to North Carolina that the dumping ends and they can receive a fair price for their shrimp." What do you make of Warner's statement?

Answer: The argument seems to rest on the idea that there exists a "fair" price for shrimp. But prices are signals about scarcity, and in the absence of government intervention they are set by the market—and the market price is the one that maximizes social surplus. Here lower prices are more than likely a result of an increase in supply, because the Vietnamese, among others, had "invested in modern technology and had lower labor costs." Lower prices for shrimp are good for net importers of shrimp, including the United States—there seems to be nothing "unfair" about that!

4. Foreign producers assert that "their shrimp imports had created 100,000 jobs in the United States." In what sectors might those jobs be created?

Answer: The article contains a good clue: the opposition from American "distributors, restaurants, grocers and food businesses." There are other less visible possibilities:
lower prices for food allow consumers to spend more money on other luxuries, which supports those industries; more efficient industries arise to take advantage of resources (capital goods, small business loans) left by the failing shrimp fishing industry.
Chapter 9: The Political Economy of Trade Policy

Article 2:
"Free Trade Debate in Australia"
By James Brooke, New York Times, Thursday, August 5, 2004

1. From the perspective of Australia, how does a free trade agreement with the United States differ from a tariff reduction that applies to all of Australia's trading partners?

Answer: Free trade areas, and other preferential trade agreements, create a discriminatory trade regime which gives preferences to one nation over others, while unilateral tariff reductions are by definition non-discriminatory. This may create inefficiencies in the global economy allowing the United States to supply Australia when it is not necessarily the lowest cost producer—it only appears to be the lowest cost producer because it does not have to pay the tariff. When this occurs, the tariff revenue lost may not make up for the gain in consumer surplus.

2. What do you make of the competing estimates ($43 million and $4 billion) of the monetary gains from the Australia-U.S. free trade agreement?

Answer: It's quite a discrepancy! The smaller number seems quite suspect, assuming average tariff rates will fall more than a single percentage point. $43 million is positively miniscule compared to Australian GDP, and the giant GDP of its future free trade partner. One might also conclude that $43 million is off the mark given that the Australian government has already committed to paying $311 million to sugar farmers because they were largely left out of the trade agreement.

3. How is it that a "free trade agreement" does not include "any opening of the American market to Australian sugar"? What does this omission mean for aggregate welfare in the United States?

Answer: In practice, many free trade agreements are fully free in name only. So in that sense the Australia-U.S. free trade agreement is not all that unusual in its incompleteness. The persistence of tariffs and quotas for the sugar industry implies that the price of sugar will be unchanged in the United States, and domestic consumers will lose out on huge potential economic gains. Interestingly, the gains to sugar producers in the U.S. from the maintenance of the trade barriers will be less than the potential gains to consumers. This makes the continuing protection of the sugar industry all the more mysterious. We must appeal to Olsonian collective action theory to explain why the less economically significant sugar industry is able to persuade the government to keep the sugar protections in place. Intuitively, the dispersion of the gains to consumers makes them less tangible, so consumers fail to mount any political opposition to the vocal sugar industry.
Chapter 10: Trade Policy in Developing Countries

**Article 1:**
"U.S. Will Cut Farm Subsidies in Trade Deal"
By Elizabeth Becker, New York Times, Saturday, July 11, 2004

1. Can you explain why U.S. farm subsidies (and similar programs in many wealthy countries) have such a large and negative impact on the developing world?

Answer: American subsidies encourage greater production of cotton and other agricultural goods by American farmers. This increases the supply of subsidized goods on global markets, and reduces their price. For developing countries this results in, in our terminology, a deterioration in their "terms of trade"—a lower value for their exports. Thus participating in trade becomes less remunerative for developing nations, and their welfare falls.

2. "In exchange for reducing agricultural supports, the wealthy nations are asking developing nations to reduce their tariffs on manufactured goods." Why is it odd that this tariff reduction on manufactured goods would only be done as part of an exchange? How does this relate to your textbook's discussion of import-substituting industrialization?

Answer: It is odd because reducing tariffs should be welfare-enhancing by itself! This is especially apparent given most poor countries' harmful experiences with import-substituting industrialization—more often than not it leads to a premature development of manufacturing industries. It seems reasonable to conclude that political economy considerations are necessary to explain the persistence of these and other tariffs.

3. The article states that these trade talks, taking place under the auspices of the World Trade Organization, if successful, "are expected to lead to as much as a $3 trillion gain in the world economy." If many concessions similar to the two described above take place, what is the source of these global gains?

Answer: These dramatic gains come from an improved allocation of resources in the global economy. In the absence of trade-distorting subsides and tariffs, each country will be able to produce goods in its comparative advantage. For wealthy countries this is often high-tech manufactured goods, and for many developing countries this comparative advantage remains in agricultural goods.
Chapter 10: Trade Policy in Developing Countries

*Article 2:*
"China Agrees to Phase Out Tax on Imported Chips"
By Elizabeth Becker, New York Times, Friday, July 9, 2004

1. Could you characterize China’s value-added tax on imported semiconductors as import-substituting industrialization?

Answer: Absolutely. China had created a tax system that favored domestic producers over foreign ones, in a relatively high-tech industry. Like similar tariff measures, this served to boost domestic production by raising the relative price of imports.

2. Why will lowering the tax on imported chips be a better development strategy than ISI for China?

Answer: The lower tax on imported semiconductors should be a boon for the overall economy, despite a shrinking domestic semiconductor industry. Consumers will benefit from lower prices. Note that most consumers of semiconductors, which include many major computer components, are other firms whose costs were higher as a result of the tax. Further gains come from the resources freed up from the shrinking semiconductor industry that will be reallocated to sectors better reflecting China’s comparative advantage.

3. Outside of China, who else is a winner in the semiconductor tax reduction?

Answer: Many groups, it seems! The Bush administration is coming out a winner in the political arena given the omnipresent anxieties regarding the trade deficit and trade in general. As the largest foreign suppliers to the Chinese market, American semiconductor manufacturers are probably the biggest foreign winners. That said, manufacturers in Japan, Taiwan, Singapore, and Korea will also benefit from less discriminatory access to Chinese consumers and businesses.
Chapter 11: Controversies in Trade Policy

"India Sees Backlash Fading Over Boom in Outsourcing"
By Saritha Rai, New York Times, Wednesday, July 14, 2004

1. Outsourcing, sometimes defined as "purchasing services from outside of the company rather than providing them internally", has become highly controversial when the services are outsourced to foreign companies. What has motivated the outsourcing of software services to from the United States to India?

Answer: According to the article, there appears to be a solid economic rationale, "to take advantage of the country's skilled, cheap, English-speaking labor force."

2. Despite the fading "backlash", why do you think outsourcing was so controversial in the first place?

Answer: Like most international trade, outsourcing has some distributional effects. In other words, some groups in the economy benefit, while others lose out—though the monetary gains of the winners are almost always larger than the monetary cost to the losers. Because it is software services that are being outsourced, those that produce software services in the U.S. will experience reduced earnings. This might be particularly scary because international trade was typically believed to hurt only labor-intensive manufacturing industries.

3. What are the "advantages of the globalization of services"?

Answer: Allowing free trade in more things improves the global allocation of resources, causing services to be produced in the most efficient location. This lowers costs for businesses engaged in outsourcing, which benefits their shareholders and lowers prices for consumers. As in standard trade theory, purchasing something more cheaply abroad is a net gain for the United States.

4. Legislators at the local, state, and national levels have been under pressure to respond to increased outsourcing. What will be the impact of a Congressional amendment "that prohibits the use of offshore workers on some government jobs"?

Answer: There will be diverse consequences. Many American software workers will benefit, and many Indian software workers will be worse off. Many businesses will be worse off, as will American consumers as a result of higher prices. The government will also be forced to pay more for services that could be outsourced, impacting government finances and ultimately hurting the American taxpayer. Therefore a group of American software service providers benefits at the expense of the rest of society. Note that there may be legitimate reasons to restrict government outsourcing based on national security or privacy concerns.
Chapter 12: National Income Accounting and the Balance of Payments

**Article 1:**
"Downside as Deficit Deepens"
By Jonathan Fuerbringer, New York Times, Sunday, September 12, 2004

1. What does the article claim the "downside" is of a deepening deficit?

Answer: In some scenarios, "interest rates may go higher and the dollar lower."

2. The article states that "the deficit could top $600 billion for the year, swamping the record of $531 billion set last year." Is this the right comparison?

Answer: The comparison is not ideal. To get a better idea of the relative scale of the deficit, it makes sense to compare it to the size of the economy. However, the economy would have to grow by twelve percent in 2004 to keep the current account deficit constant as a percentage of GDP. So the comparison may be valid after all.

3. According to the article, "Currency strategists worry that the deficit must be covered by money from abroad." Why must money from abroad cover the current account deficit?

Answer: The current account deficit implies the U.S. is buying more goods from foreigners than foreigners are buying from the United States. The excess goods must be purchased with something other than goods, and the only alternative payment is assets. By selling assets to the rest of the world, the United States is borrowing money to buy foreign goods.

4. Is the downside that currency strategists feared actually materializing? Are you surprised?

Answer: The downside is not materializing; in fact, "foreigners bought a net $440.5 billion of American stocks and bonds, up from $326.3 billion in the first six months of 2003." This should not be surprising. The downside has clearly been overstated. Because the gap of exports and imports is by definition also the excess of investment over saving, the current account deficit is financing productive capital investment by American firms.

5. The federal government is currently running a substantial budget deficit. How might the budget deficit be related to the deficit in the current account?

Answer: The budget deficit can reduce national savings. All other things equal, this will increase the size of the current account deficit. Intuitively, either domestic savings is being soaked up by government bonds, or foreigners are lending to the American government. In practice, foreigners are helping to finance both the budget deficit and domestic investment.
Chapter 12: National Income Accounting and the Balance of Payments

Article 2:
"04 Trade Deficit Sets Record, $617 Billion"
By Elizabeth Becker, New York Times, Friday, February 11, 2005

1. The trade deficit has set a new record in 2004, "soaring to $617.7 billion." Why does this also imply that there was record borrowing from foreigners by Americans in 2004?

Answer: We know there must be parity between the current account and the sum of the capital and financial accounts. If Americans buy more goods from abroad than foreigners by from the U.S., then Americans must be paying for some foreign goods with something other than American goods. The only other option is American assets, especially stocks and bonds. So exchanging stocks and bonds for $617.7 billion in foreign goods is equivalent to foreigners lending Americans the money to buy those goods.

2. "Domestic manufacturers, labor unions and many Democrats say the huge trade deficit reflects the erosion of the American manufacturing base and a concurrent loss of jobs." Do you agree with this claim?

Answer: You shouldn't! American workers may be losing out in the manufacturing industry, but this has more to do with comparative disadvantage than the trade deficit.

3. According to the Secretary of Treasury, "the American economy was growing faster than the economies of other advanced industrial nations. The imbalance…reflects the ability of American consumers to buy more imports." Do you agree with this claim?

Answer: It is certainly closer to the truth than the previous claim. Because the trade deficit represents the gap of investment over national savings, American firms and consumers must be very confident about future productivity and related economic prospects.

4. "Pete Morici, a professor of business at the University of Maryland, said the deficit was 'the single most important tax on U.S. growth and burden on American working families.' Is this the right way to think about the trade deficit?

Answer: Emphatically not. The trade deficit is not a tax in any sense of the word. It represents the collective decisions of millions of consumers and firms, based on their incomes and expectations, and their responses to market signals, to borrow money. A tax represents an involuntary economic burden placed on economic agents by the government, while the trade deficit represents the aggregation of a set of individual voluntary decisions.

5. Should the trade deficit add "further pressure to forces pushing down the value of the dollar"?
Answer: Probably not, unless foreign investors find the logic of domestic manufacturers and Pete Morici more compelling than the more accurate perspective of the Treasury Secretary.
Chapter 13: Exchange Rates and the Foreign Exchange Market: An Asset Approach

"Industry and Labor Step Up Fight Over China's Currency"
By Elizabeth Becker, New York Times, Friday, September 10, 2004

1. Why are "industry and labor" so worked up about the exchange rate with China?

Answer: Let's assume for a moment that it is more than just a political ploy. They claim the exchange rate is "undervalued by as much as 40 percent" and that this "provided a huge subsidy to China's exports." It is true that exchange rates affect the relative prices of goods denominated in foreign currencies, and that a depreciation the Chinese currency will make Chinese goods appear cheaper to Americans. Therefore American producers that compete in the U.S. with Chinese exporters will be hurt by an "undervalued" currency. Keep in mind that the yuan has not recently experienced a depreciation—it has been pegged to the dollar for the last decade!

2. As an American consumer, how are you affected by an "undervalued" Chinese currency? Is it really unfair?

Answer: The cheap yuan is not an unambiguous detriment to the American economy. For every American manufacturer that is hurt by cheap Chinese goods, there are countless consumers, not to mention importing firms, that benefit from lower import prices. This sounds a lot like the gains from trade.

3. Are there other reasons, beyond the level of the exchange rate, that some American industries are having trouble competing with the Chinese?

Answer: Certainly. The article offers a strong possibility: "China enjoys other economic advantages deriving from its ability to produce increasingly sophisticated goods with cheap labor". This is consistent with our always-useful intuition from the Heckscher-Ohlin model: China is labor-abundant, so we would expect them to slowly displace labor-intensive industries in the U.S. with their imports.

4. What would have to be true about asset returns in China and the United States to make the yuan appreciate?

Answer: According to interest rate parity, interest rates in China would need to be much lower than those in the U.S.—that way an appreciation of the yuan would bring parity to returns of dollar and yuan denominated assets.
Chapter 14: Money, Interest Rates and Exchange Rates

Article 1:
"Europeans, Hopeful on Growth, Leave Rates Unchanged"
By Mark Landler, New York Times, Friday, September 3, 2004

1. Jean-Claude Trichet has had to factor "continued volatility in the oil markets" into his already complex job of running the European Central Bank. How will higher oil prices affect macroeconomic variables that concern Mr. Trichet?

Answer: Because Europe is a net importer of oil, an increase in oil prices is a deterioration in the terms of trade. The change in relative prices reduces income in the euro area, while simultaneously increasing the average level of prices.

2. The article suggests that slower global growth is likely, and data suggest that growth may be slowing in Germany already. In light of your answer to the first question, how might higher oil prices help explain Trichet's decision to leave interest rates unchanged despite signs of a sluggish economy?

Answer: To lower interest rates, the E.C.B. will have to increase the money supply. In the long run we know that a higher money supply will create inflation. Given that higher oil prices have already increased the risk of inflation, Trichet may be reluctant to create any further inflationary pressures. The desire to keep inflation low is therefore making it difficult for the E.C.B. to cut interest rates to boost the economy.

3. Explain how the appreciation of the euro has "minimized the risks in oil prices."

Answer: Because oil prices are typically denominated in dollars, the appreciation in the euro against the dollar will reduce the euro price of oil. The appreciation itself is therefore deflationary, and should make the European Central Bank's job easier.
Chapter 14: Money, Interest Rates and Exchange Rates

Article 2:
"Tea Leaves and Dollars: Read 'em and Weep"
By Jonathan Fuerbringer, New York Times, Saturday, January 15, 2005

1. Let's walk through the chain of events started by Mr. Poole's comments. Why did Treasury prices fall after the president of the St. Louis Fed suggested interest rate increases could come more quickly than expected?

Answer: A bond's price moves in the opposite direction from its interest rate: because the principal payment is fixed, a lower price for it now yields a higher rate of return. Interest rates on different assets with similar time horizons tend to move together, so the Treasury interest rate rose along with expectations about the Fed changing its target rate.

2. What is the relationship between the Federal Reserve boosting interest rates and the value of the dollar/euro exchange rate?

Answer: Higher rates of return on dollar deposits, including Treasuries, as compared to euro deposits, create a temporary increase in demand for dollars as investors seek to take advantage of greater returns in the United States. In response to greater demand the dollar appreciates, which restores interest rate parity between the dollar and euro.

3. We learn in the article that the dollar fell 1.1% against the euro on news about the trade deficit, and then appreciated almost as much the next day. Is this an example of "overshooting"?

Answer: No. Overshooting happens over longer periods of time once prices have a chance to adjust. This episode seems to be caused by investors overreacting to news about the trade deficit.

4. The article also notes that the CPI and PPI have been growing at record rates recently. Why would higher inflation affect peoples' expectations about interest rates?

Answer: There is a long-run relationship between prices and the money supply. Because the Federal Reserve's goal is to keep inflation low, they will reduce the money supply now in anticipation of higher inflation in the future. However, because money is not neutral in the short-run, interest rates will rise in response to a reduction in the money supply.
Chapter 15: Price Levels and the Exchange Rate in the Long Run

"As Prices Rise in China, Signs of Inflation"
By Keith Bradsher, New York Times, Friday, April 9, 2004

1. What is wrong with the title, "As Prices Rise in China, Signs of Inflation"?

Answer: An increase in the level of prices is, by definition, inflation. So the title is redundant. One might have simply titled the article, "Prices Rise in China" or "Signs of Inflation in China" to the same effect.

2. The article attributes the rising "inflationary pressures" to "China's rapidly growing economy". Drawing from the article and theories of exchange rates, what else might be causing higher inflation?

Answer: From the monetary approach to exchange rates, we know that one of the common sources of price level movements is changes in the money supply; therefore the People's Bank of China could be increasing the supply of currency in the economy. Alternatively, the industrial price index, which includes both domestic and imported goods, may be rising due to the higher costs of raw materials, whose prices have been "rising across the globe." In other words, the inflation may not have a purely domestic cause.

3. Assuming that the People's Bank of China would like to keep the nominal exchange rate constant, can you explain why a central bank official would play down external data sources that suggest inflation may be up to 3% on the consumer front?

Answer: According to our most basic theories of purchasing power parity, higher inflation should produce a nominal depreciation, which would be counter to the Bank's stated goals.

4. Let's assume that the nominal exchange rate is unchanged, despite inflation in both producer and consumer prices. What happens to the real exchange rate?

Answer: Holding the nominal exchange rate constant (and further assuming that foreign variables are constant), an increase in Chinese prices results in a real appreciation of the Chinese currency, the yuan. This real appreciation represents an increase in the purchasing power of the yuan relative to foreign currencies.
Chapter 16: Output and the Exchange Rate in the Short Run

"Upside to a Dollar That's Falling"
By Jonathan Fuerbringer, New York Times, Sunday, November 7, 2004

1. Will the falling dollar shrink America's current account deficit?

Answer: Maybe. If the falling dollar represents a real depreciation, American exports will be cheaper for foreigners and imports into the U.S. will become more expensive for American consumers and firms. The volume of imports will probably fall, but because their value may rise, it's not entirely clear the direction the current account will take. The empirical evidence provides little clarification.

2. According to the article, a dollar "decline…would not be all bad, although it would hurt those who travel abroad – and everyone who buys imported items." How bad is that?

Answer: Pretty bad! Everyone buys imported goods. All other things equal, a dollar decline reduces the real value of every consumer's income.

3. The article describes the falling dollar as "good for business at home." Is it?

Answer: It's not quite so simple. A cheaper dollar should raise demand for exporting firms, and raise prices for import-competing firms. However, for firms that rely on intermediate inputs from abroad, the cheaper dollar will raise costs.

4. What does the current account deficit, which "should top $600 billion," mean about foreign borrowing? Is this cause for concern?

Answer: By definition, the current account balance is equal to the difference between savings and investment. As a deficit, this implies that the U.S. is borrowing money, or as the article notes, "net inflows of capital from abroad." This foreign borrowing need not be a concern, as the money is financing the expansion of the American capital stock to a degree that would be impossible without global credit markets.
Chapter 17: Fixed Exchange Rates and Foreign Exchange Rates

"China Says It Won't Sell Dollars"
By Keith Bradsher, New York Times, Monday, March 7, 2005

1. The article reveals that China has "$609.9 billion in foreign exchange holdings." Why does the central bank hold such massive reserves?

Answer: A fixed exchange rate requires a central bank that is committed to intervene in the foreign exchange market to smooth out rapid shifts in supply and demand. In order to buy yuan on the currency market, the central bank must sell dollars. In order to sell dollars, the bank needs to hold dollar-denominated assets in its reserves. The greater the Bank of China's reserves, the more credible its commitment is to the fixed exchange rate.

2. Given the "rapid accumulation of dollar-denominated assets," what must China do to keep the domestic money supply unchanged?

Answer: The central bank must undertake a sterilized intervention. Starting from the beginning, the central bank must be buying Treasury bonds with yuan. This increases the amount of yuan on global currency markets and in the domestic economy. It must now soak up those yuan by selling yuan-denominated bonds. So the quantity of yuan is unchanged, and some Treasury bonds on world markets have been replaced with yuan-denominated bonds. This will allow the Bank of China to manage the exchange rate only if dollar bonds and yuan bonds are imperfect substitutes.

3. Why might it be important for Mr. Guo to repeatedly verbally commit to the fixed exchange rate?

Answer: Speculators in the currency market will look for any signal from central bank officials that they are looking to float the yuan or move the peg to a new level. If market participants believe the yuan will be revalued, for example, they will buy the yuan because they know it will be worth more in the future. If the Bank of China cannot adequately respond to the speculation, then the currency will rise in value, and China's credibility will be damaged. So Mr. Guo is reiterating his commitment to minimize the chance of a move by currency speculators.

4. Is China in danger of a balance of payments crisis?

Answer: It seems unlikely, for two principal reasons. First, the Bank of China's gargantuan foreign exchange reserves give it significant flexibility to intervene as necessary to defend the peg. Second, because speculation seems to be that the yuan will revalue (this is what Americans are pressuring the Chinese to do), not devalue, the Chinese can defend against this speculation by selling yuan, of which they have an unlimited supply! This could become problematic in terms of domestic monetary goals, as selling yuan will increase the domestic money supply and eventually spark inflation.
Chapter 18: The International Monetary System, 1870-1973

"I.M.F. Accepts Standstill to Let Argentina Work on Debt"
By Todd Benson, New York Times, Wednesday, September 1, 2004

1. How does the Bretton Woods-era role of the I.M.F. seem to relate to the role the Fund has taken in Argentina?

Answer: It seems quite unrelated! While member countries do make resources available to the I.M.F. for lending to "countries in need", in Argentina the Fund is lending billions of dollars over long terms to a country that no longer has a fixed exchange rate.

2. The I.M.F. is available to help countries maintain "internal balance". How is Argentina doing internally?

Answer: Things seem excellent. "[T]he economy is growing at a robust pace and tax revenues are booming."

3. Given your answer to the previous question, is the I.M.F. in Argentina to help with the "internal balance"? What other role might the I.M.F. be playing?

Answer: Since the Argentine economy is doing well internally, they don't seem to need the Fund’s help with their internal balance. This leaves, of course, the external balance: the exchange rate and the current account. However, the article makes no mention of either macroeconomic variable. If anything, the I.M.F. is there to manage the Fund's lending, and to weigh in on the sovereign debt restructuring negotiations with Argentina's other lenders.
Chapter 19: Macroeconomic Policy and Coordination under Floating Exchange Rates

Article 1:
"I.M.F. Asks China to Free Its Currency From Dollar"
By Elizabeth Becker, New York Times, Thursday, September 30, 2004

1. Why do you think Representative Sander M. Levin is so eager to see China float its currency?

Answer: He and other likeminded members of Congress claim that "China has violated trade laws by failing to revalue its currency." Because Levin represents a fairly manufacturing-intensive state, he must believe that a floating yuan will appreciate, which will, at least temporarily, increase the price of Chinese exports into the United States. This argument raises two problems. First, higher-priced Chinese exports seem great for Michigan manufacturers, but bad for everyone else. Second, a floating yuan is not guaranteed to appreciate.

2. Why would moving to a flexible exchange rate "also help tame inflation in China"?

Answer: By committing to a fixed exchange rate, the People's Bank of China must subordinate domestic monetary policy to need to intervene in currency markets. For example, an exogenous increase in demand for yuan forces the central bank to sell yuan. This increases the money supply in China, which could produce inflation. By allowing the yuan to float, the central bank could instead pursue domestic price stability.

3. What are some disadvantages that would accompany a Chinese move to a flexible exchange rate?

Answer: A fixed exchange rate imposes discipline on monetary authorities. In the absence of a target that can be seen on a daily basis by all market participants, central bankers may succumb to pressure to manipulate the money supply for political goals, leading to high inflation. Also, without futures markets that allow traders to hedge foreign exchange risk, a flexible currency can create greater uncertainty in international transactions. Thus a credible peg may do more to encourage international trade in goods and assets.
Chapter 19: Macroeconomic Policy and Coordination under Floating Exchange Rates

Article 2:
"Central Bank Remains Silent as the Euro Rises"
By Mark Landler, New York Times, Friday, December 3, 2004

1. Does the article offer a hint as to why the euro has appreciated so much?

   Answer: Not much guidance is provided. There is the idea that the situation "is not a home-grown phenomenon, but a result of the dollar's decline." That would certainly be true if the euro were declining against the dollar, but not against other currencies. If it does have more to do with the United States than the countries of the euro-zone, then, according to the article, "analysts say the dollar could slide another 20 percent against the euro, given the ballooning trade deficit in the United States." View this claim with some skepticism, as this economist is unaware of any empirical evidence that trade deficits cause depreciations.

2. Why might the ECB, and Europeans in general, be concerned about the appreciation of the euro?

   Answer: Because an appreciation increases export prices and reduces import prices, it tends to contract aggregate demand for national output, which can reduce income in the short run.

3. Despite describing the euro appreciation as "not welcome," why have Jean-Claude Trichet and the European Central Bank hesitated about intervening?

   Answer: The article implies that "[i]ntervening in the face of such market forces would be a highly risky undertaking," probably because the size of any intervention would be small relative to the transactions of millions of private investors. There's another good reason for hesitating that the article does not bring up. Appreciations are deflationary, because they reduce the price of imports, and fighting inflation is the primary goal of any central bank. In other words, selling euros and buying dollars would increase the money supply, raise inflation, and in doing so harm the credibility of the relatively young ECB.

4. Why do you think an intervention, spearheaded by the ECB and the Bank of Japan, to increase the value of the euro "would almost certainly not have the support of the Federal Reserve"?

   Answer: Perhaps for the same reason that the ECB is concerned about the appreciation of the euro—the impact on aggregate demand. As of December 2004, the United States was in the midst of a still sluggish economic recovery. Policymakers at the Fed might be reluctant to do anything, such as appreciate the dollar, to jeopardize that recovery or increase the deficit in the current account.
Chapter 20: Optimum Currency Areas and the European Experience

"In Eastern Europe, Skepticism Over the Euro"
By Mark Landler, New York Times, Monday, December 6, 2004

1. What are some disadvantages of joining the euro zone that some Eastern European nations might be concerned about?

Answer: The big drawback that the article highlights is the "one-size-fits-all monetary policy" of the current euro zone. This makes it difficult to smooth out business cycles that aren't synchronized with the rest of the zone—as seems to be the case for Poland.

2. The Slovakian finance minister suggests that "joining the euro zone would add half a percentage point to a full point to his country's annual economic growth." Why might this happen?

Answer: The finance minister is probably referring to the gains that will come from increased factor mobility and trade with the other euro countries. This increased integration will result from eliminating exchange rate uncertainty and the costly need to hedge foreign currency risk in asset markets. There is a fair amount of empirical evidence that exchange rate uncertainty can be a natural barrier to trade.

3. Several countries seem to be having some trouble getting ready to join the euro zone. Why do you think the stringent Maastricht criteria related to the size of the budget deficit are necessary?

Answer: Historically speaking, stable, low-inflation members of the EU were concerned about tying their fates to nations that had a history of fiscal irresponsibility and higher inflation. So much emphasis is put on the budget deficit in particular because large stocks of government debt give central bankers a perverse incentive to increase inflation to reduce the real value of the debt—that is, unless the central banker is sufficiently insulated from political pressure.

4. Can you determine any disadvantages to running your own monetary policy from the article?

Answer: Hungary seems like a good example, as "the central bank modestly devalued the forint, and traders promptly dumped the currency." Foreign investors can be especially punishing on central banks that have yet to establish any long-term credibility. Investors may have believed that Hungary's devaluation was an attempt to achieve greater export competitiveness temporarily in exchange for higher inflation. As inflation should be a central bank's foremost enemy, this was not a promising signal. This historical episode serves as an example of what can be gained by adopting the monetary policy of more credible trading partners.

"Private Investors Abroad Cut Their Investments in the U.S."
By Eduardo Porter, New York Times, Tuesday, October 19, 2004

1. What are two things that might be motivating private investors to enter U.S. capital markets?

Answer: Your textbook offers two possibilities: intertemporal trade and portfolio diversification. The desire to move consumption from the present into the future would cause foreigners to engage in intertemporal trade by buying American assets. The need to reduce portfolio risk causes foreign investors to include a number of countries in their selection of assets, including the United States.

2. Why are private investors leaving American capital markets?

Answer: The article offers a possibility, that "investors appear to be concerned over cooling growth and a rising American trade deficit." Both lower profits and a declining dollar could reduce the returns on American assets measured in foreign currencies, which could lead foreigners seeking to boost future consumption to look elsewhere.

3. In contrast to private investors, what do you think is motivating foreign central banks to remain in U.S. capital markets?

Answer: Answers will vary. The article suggests that Japan, for example, is "intervening to keep the value of its currency from rising." In general, foreign central banks like to accumulate dollar-denominated assets to enhance their ability to defend their currency against future speculations—especially Asian central banks since the Asian Financial Crisis of 1997-1998.

4. What gains is the U.S. experiencing from access to international capital flows?

Answer: International capital flows have allowed American firms and the federal government to engage in hundreds of billions of dollars of intertemporal trade. The current account deficit implies that this intertemporal trade has been in the form of borrowing. To the extent that this borrowing is financing domestic capital formation, the gains are clear. In the case of the federal budget deficit, the gains are not so clear. The American consumer also benefits from these capital flows, in that they experience the gains from a greater capital stock despite the low personal savings rate.
Chapter 22: Developing Countries: Growth, Crisis, and Reform

"Argentina Starting Drive to Emerge From Default"
By Todd Benson, New York Times, Wednesday, January 12, 2005

1. Refresh yourself on the background a little bit. What led Argentina to "the biggest sovereign default in history"?

   Answer: A combination of factors caused it, but the two most salient seem to be a real appreciation of the peso and the global economic slowdown that began at the end of 2001. The real appreciation of the peso, in the absence of a flexible labor market and consequent movement in nominal wages, led to poor export performance and a macroeconomic slump. The global economic slowdown and widespread risk aversion after September 11, 2001 reduced foreigners' willingness to continue to lend to the Argentine government. So poor macroeconomic performance reduced tax revenue at exactly the same time that foreign credit dried up, and Argentina was forced to default.

2. Given that it has already defaulted, why is Argentina working so hard to renegotiate the defaulted debt?

   Answer: Argentina's past behavior has made it unable to access international financial markets. All governments, Argentina included, often find it useful to access international credit markets—for short-term liquidity needs or longer term investment projects. In the past obviously Argentina has bitten off more than it can chew, but would still like to regain the confidence of foreign lenders. Thus it is offering creditors a middle ground between complete default and complete repayment.

3. Why do you think some of Argentina's creditors are holding out for more money?

   Answer: Because they believe Argentina can afford to pay more. They may be on to something, as the Argentine "economy has grown 8 percent annually for two years, leaving a windfall of tax revenue."