CHAPTER 2
Why Countries Trade

MULTIPLE-CHOICE QUESTIONS

1. Which of the following statements is true?
   a. International trade is nothing like interregional trade.
* b. International trade and interregional trade occur for similar reasons.
   c. International trade is bad for a country.
   d. Interregional trade occurs only in the U.S.
   e. Only the U.S. has data on interregional trade.

2. International trade in a single product:
   a. would tend to lower the price in the exporting country.
   b. would tend to increase the price in the importing country.
* c. would tend to increase the price in the exporting country.
   d. would not affect the price in either country.
   e. None of the above.

3. Which of the following statements is false?
   a. The price of the traded good rises in the exporting country.
   b. The production of the traded good rises in the exporting country.
* c. The production of the traded good falls in the importing country.
   d. The price of the traded good rises in the importing country.
   e. The price of traded goods will change in both countries.

4. Adam Smith stated that trade was:
   a. a zero sum game.
   b. to be controlled by government to maintain a surplus.
* c. beneficial to all countries.
   d. beneficial to large countries that can reduce costs.
   e. not beneficial to any country.

5. The Mercantilists believed:
* a. that international trade was a zero-sum game.
   b. that international trade was an n-sum game.
   c. that maximizing a country's imports would improve its welfare.
   d. that exports were detrimental to a country's economy.
   e. that gold was unimportant.

6. Which of the following is not true about the Mercantilists?
   a. Wealth was equated with holdings of gold and silver.
   b. A trade deficit was bad.
   c. A trade surplus was good.
* d. Trade was considered to be an n-sum game.
   e. The stock of gold was important.

7. The economic philosophy that favors strict limits on imports and strong support for exports is called:
   a. zero sum.
   b. autarky.
* c. mercantilism.
   d. comparative advantage.
   e. monetarism.

8. The Mercantilists advocated:
   a. lower labor costs to increase exports.
   b. tariffs and quotas to reduce imports.
   c. trade policies designed to cause an inflow of gold.
* d. All of the above
   e. None of the above

9. The theory that suggests that a country's wealth is based on the amount of gold it holds is called:
   a. absolute advantage.
* b. mercantilism.
   c. comparative advantage.
   d. factor-proportion.
   e. Dutch factor.

10. Specialization and trade by countries based on absolute advantage results in:
   a. a faster depletion of the world's resources.
   b. products produced at higher cost.
* c. the world using its resources more efficiently causing an increase in world output.
   d. the world using its resources more efficiently causing a decrease in world output.
   e. a reduction in world output.

11. Absolute advantage is a trading principle that states that:
   a. differences in resource endowments determine comparative advantage.
   b. differences in incomes determine comparative advantage.
* c. absolute cost differences determine the basis for trade.
   d. relative cost differences determine the basis for trade.
   e. differences in exchange rates cause trade.

12. The theory of absolute advantage developed by Adam Smith was based on the assumption that:
    a. capital was the only factor of production.
*   b. labor was the only factor of production.
    c. capital and labor were the only factors of production.
    d. absolute advantage was a myth.
    e. None of the above

13. Smith's theory of absolute advantage is based on:
*   a. the labor theory of value.
    b. opportunity costs.
    c. absolute theory of value.
    d. capital theory of value.
    e. high labor costs.

14. What proportion of international trade is based on absolute advantage?
    a. None
*   b. Some
    c. Most
    d. All
    e. Absolute advantage and international trade are uncorrelated.

15. Which of the following economists showed that international trade was mutually beneficial based on the concept of absolute advantage?
*   a. Adam Smith
    b. David Ricardo
    c. James Ingram
    d. Paul Samuelson
    e. Paul Krugman

16. Which of the following economists discovered the basic idea of comparative advantage?
    a. John Maynard Keynes
*   b. David Ricardo
    c. Paul Samuelson
    d. Milton Friedman
    e. Paul Krugman

17. If a country has a(n) _____ advantage in the production of a particular good, its opportunity cost of producing that good is lower than the opportunity cost for the trading partner for producing the same good.
*   a. comparative
    b. absolute
    c. interim
    d. mercantilist
    e. None of the above

18. An economy without international trade is an economy in a state of:
    a. disequilibrium.
    b. economic depression.
*   c. autarky.
    d. economic expansion.
    e. perfect equilibrium.

19. An economy that does not trade is referred to as an economy in a state of:
    a. macroeconomics.
    b. institutional decay.
*   c. autarky.
    d. unnecessary simplification.
    e. rapid growth.

20. If a country has lower overall productivity levels than its trading partners, then:
    a. it will be unable to export.
    b. it will have a trade deficit.
    c. it will not be able to obtain gains from trade.
*   d. it will have a lower standard of living than its trading partners.
    e. it will have a trade surplus.

21. To say that the U.S. possesses a comparative advantage over Japan in the production of certain types of music implies that (for a similar quality of music) the:
    a. opportunity cost of production is less in Japan.
    b. absolute cost of production is less in the U.S.
    c. absolute cost of production is less in Japan.
*   d. opportunity cost of production is less in the U.S.
    e. opportunity cost of production is higher in the U.S.

22. When economists talk about the gains from trade, they mean that:
    a. no one ever gets hurt by trade.
*   b. the benefits of trade outweigh the losses.
    c. business firms benefit from trade but not necessarily individuals.
    d. trade increases government revenue through taxes on imports.
    e. None of the above

23. According to the theory of comparative advantage, the most important benefit of trade is:
    a. more jobs.
*   b. a more efficient allocation of resources.
    c. trade surpluses.
    d. increased exports.
    e. increased imports.

24. When country A uses fewer resources to produce a product than another country, then:
    a. country A has a comparative advantage in the production of the product.
*   b. country A has an absolute advantage in the production of the product.
    c. country A has a comparative disadvantage in the production of the product.
    d. country A has an absolute disadvantage in the production of the product.
    e. None of the above

25. If a country has an absolute advantage in two products and has a comparative advantage in only one product, what should it do?
    a. Produce both products and export them to maximize its returns.
*   b. Specialize in the product it has a comparative advantage in and import the other.
    c. Produce both products and export the cheapest and import the most expensive.
    d. Produce both products and export the most expensive and import the cheapest.
    e. It should not trade.

26. Gains from specialization and trade are basically:
*   a. what a country can consume after trade beyond what it can consume before trade.
    b. short-term gains that must be reinvested immediately.
    c. long-term gains that are not as good as domestic production.
    d. what a country can trade without losing its absolute advantage.
    e. cheaper imports only.

27. Gains from specialization and trade apply to:
*   a. both countries that trade.
    b. only the country that imports a product.
    c. only a country that exports a product.
    d. only trade in cloth.
    e. only trade in machines.

28. If the U.S. exports machines and India exports cloth, which of the following statements would be false?
    a. India can consume more with trade.
    b. The U.S. can consume more with trade.
    c. World production of machines and cloth will rise.
    d. India would be worse off because they would consume less.
    e. None of the above

Output per unit of Labor	Scooters	Picture Frames
Holland	8	2
U.S.	5	2

29. Based on the information above, if the two countries specialize and trade the U.S. will export _____ and Holland will export _____ .
    - a. scooters, scooters
    - b. scooters, picture frames
    - * c. picture frames, scooters
    - d. picture frames, picture frames
    - e. scooters, nothing

30. With free trade, the minimum limit on the amount paid for one picture frame is _____ scooters.
    - a. 0.25
    - b. 0.80
    - * c. 2.50
    - d. 4.00
    - e. 4.50

31. Which of the following is a viable world price for one scooter?
    - a. 0.8 PF
    - b. 2.2 PF
    - * c. 0.3 PF
    - d. 8.5 PF
    - e. 10 PF

Answer questions 32. – 36. based on the following information. A worker in the U.S. can produce either 5 machines per day or 15 yards of cloth. A worker in India can produce either 1 machine per day or 5 yards of cloth.

32. Which of the following statements is false?
    - a. India has a comparative advantage in the production of cloth.
    - b. The U.S. has a comparative advantage in the production of machines.
    - c. The U.S. has an absolute advantage in the production of machines.
    - * d. India has a comparative advantage in the production of machines.
    - e. India does not have a comparative advantage in either product.

33. Which of the following statements is true?
    - a. India has an absolute advantage in the production of machines.
    - b. The U.S. has an absolute advantage in neither machines nor cloth.
    - * c. The U.S. has a comparative advantage in machines.
    - d. The U.S. has a comparative advantage in cloth.
    - e. The U.S. does not have a comparative advantage in either product.

34. In India the price of machines in terms of cloth (marginal rate of transformation) is:

* a. 1M = 5C.
b. 1M= 4C.
c. 1M= 3C.
d. 1M = 2C.
e. 1M = 1C

35. In the U.S., the price of machines in terms of cloth (marginal rate of transformation) is:

a. 1M = 1C.
b. 1M = 2C.
* c. 1M = 3C.
d. 1M = 4C.
e. 1M = 5C

36. Trade between India and the U.S. would definitely occur where the price of machines in terms of cloth (terms of trade) is:

a. 1M = 2C.
* b. 1M = 4C.
c. 1M = 6C.
d. 1M = 7C.
e. 1M = 8C

37. If Dutch labor can produce 3 soda pops or 5 yogurt cones in a day, while British labor can produce 2 soda pops and 4 yogurt cones, then _____ has a comparative advantage in yogurt cones.

* a. the U.K.
b. the Netherlands
c. both the U.K. and the Netherlands
d. neither
e. There is not enough information to answer this question.

Assume that a unit of labor in Bulgaria can produce 12 brooms or 15 hats per day. For Albania assume that a unit of labor can produce 18 brooms or 24 hats per day.

38. In Bulgaria the price of brooms in terms of hats is:

* a. 1B = 1.25H.
b. 1B = 1H.
c. 1B = .75H.
d. 12B = 18H.
e. 15B = 20H.

39. _____ has a comparative advantage in the production of brooms and _____ has a comparative advantage in the production of hats.

  a. Bulgaria, Bulgaria
* b. Bulgaria, Albania
  c. Albania, Albania
  d. Albania, Bulgaria
  e. Neither country has a comparative advantage in brooms.

Answer questions 40 – 43. based on the following information. A worker in the U.S. can produce either 10 chips or 20 sodas per day. A worker in Mexico can produce either 20 chips or 60 sodas per day.

40. Which of the following is true?

  a. The U.S. has an absolute advantage in the production of chips.
  b. The U.S. has a comparative advantage in the production of sodas.
  c. The U.S. has an absolute advantage in the production of sodas.
* d. The U.S. has a comparative advantage in the production of chips.
  e. Neither country has a comparative advantage in chips.

41. Which of the following is false?

* a. Mexico has an absolute disadvantage in the production of chips.
  b. Mexico has a comparative advantage in the production of sodas.
  c. Mexico has an absolute advantage in the production of chips.
  d. Mexico has a comparative disadvantage in the production of chips.
  e. Neither country has a comparative advantage in sodas.

42. Which of the following is true?

  a. The cost of chips in terms of sodas in the U.S. is 1C=3S.
  b. The cost of chips in terms of sodas in the U.S. is 1/3C=1S.
  c. The cost of chips in terms of sodas in the Mexico is 1C=2S.
* d. The cost of chips in terms of sodas in the U.S. is 1C=2S.
  e. The cost of chips in terms of sodas is 10C = 1S in both countries.

43. Which of the following would be the best ratio for Mexico in terms of the gains from trade?

* a. 1C = 2.1S
  b. 1C = 2.3S
  c. 1C = 2.5S
  d. 1C = 2.7S
  e. 1C = 3S

Consider the information below for Namibia and Malaysia to answer questions 44. – 46.

Namibian labor:	16 baskets/day or 4 lamps/day
Malaysian labor	20 baskets/day or 8 lamps/day

44. Each country specializes in the good for which it maintains a comparative advantage. In this example, Namibia will specialize in _____ and Malaysia will specialize in_____.

a. baskets, baskets
* b. baskets, lamps
c. lamps, lamps
d. lamps, baskets
e. lamps, lamps

45. Which of the following is a viable world price for one lamp?

a. 1.75 baskets
b. 2.10 baskets
* c. 3.85 baskets
d. 4.25 baskets
e. 4.50 baskets

46. Free trade between these two countries will create winners and losers. For Namibia, the losers will be those associated with _____ production; for Malaysia the losers will be those associated with _____ production.

a. basket, basket
b. lamp, lamp
* c. lamp, basket
d. basket, lamp
e. basket, basket

47. Opportunity cost is:

a. the dollar cost of producing the goods.
b. the dollar price paid for final goods and services.
c. the dollar price associated with using one good in place of another.
* d. the alternative that must be given up in order to get something else.
e. cannot be calculated.

48. Which of the following statements is true?

a. Low wages guarantee that the cost of labor is low.
b. High wages guarantee that the cost of labor is high.
* c. The cost of labor is determined by the price and productivity of labor.
d. Labor always is cheaper in poor countries.
e. Unit labor costs are irrelevant.

49. Many of the gains from trade occur through a reallocation of a country's existing resources. These are known as the _____ gains from trade.
a. monetary.
* b. static
c. opportunity
d. dynamic
e. only

50. The static gains from trade:
a. result in an increase in the quality of goods over time.
* b. are a one time event.
c. result in the increase in the size of export firms over time.
d. result in a faster rate of economic growth for countries.
e. cannot be calculated.

51. Which one of the following is not one of the dynamic gains from trade?
* a. A country uses its resources less efficiently.
b. Firms in small countries can grow to the most efficient size.
c. It may increase the quality of the goods consumed.
d. Markets in a country may become more competitive.
e. negative externalities.

52. Which of the following is not one of the dynamic gains from trade?
a. a higher rate of growth of real GDP
* b. lower product quality
c. higher product quality
d. a very effective way to promote competition
e. None of the above

53. To gain economic growth from specialization/trade, a country must often reallocate its existing resources. The economic growth that results from this process is often referred to as:
a. the autarky benefits of specialization.
* b. the dynamic gains from trade.
c. the social benefits of saving.
d. the static gains from trade.
e. negligible gains from trade.

54. Which of the following is not one of the dynamic gains from trade?
a. greater efficiency in the use of resources
b. larger gains from trade for small countries
c. increases in the quality of goods
* d. a lower rate of growth of GDP
e. None of the above

TRUE-FALSE QUESTIONS

1. F International trade occurs for very different reasons than interregional trade within a country.

2. F International trade occurs for entirely different reasons than trade among the regions of a large country such as the U.S.

3. T There are a large number of institutional differences between domestic trade and international trade.

4. F The only difference between domestic trade and international trade is the existence of tariffs on imported goods.

5. F Trade between Mississippi and Massachusetts occurs for totally different reasons than trade between Brazil and the U.S.

6. T Prices of traded goods fall in the importing country and rise in the exporting country.

7. F Production of traded goods falls in countries that export them.

8. F Importing countries produce more of the goods they import in order to replace those imports with domestic production.

9. F Abstraction is something that only occurs in economic theory.

10. F The Mercantilists advocated that each country should try to create balanced trade by having exports equal to imports.

11. T The Mercantilists believed that international trade was a zero-sum game.

12. F International trade can best be described as a zero-sum game.

13. T The Mercantilists equated wealth with holdings of gold and silver.

14. T The Mercantilists believed that imports were "bad" because they led to an outflow of gold and silver from the country.

15. T Modern international trade theory really started with the publication of Adam Smith's *The Wealth of Nations* in 1776.

16. F International trade allows the world to use its resources more efficiently but one country's gains are another country's losses.

17. F According to Adam Smith, international trade is based on comparative advantage.

18. F In a two-country world, at least one country must lose from trade.

19. T Specialization and trade increase the world's output of goods and services.

20. T A country's ability to produce a specific good with fewer resources than another country determines whether it has an absolute advantage in producing the good.

21. F A country's ability to produce a specific good with fewer resources than another country determines whether it has a comparative advantage in producing the good.

22. F The only reason why countries conduct international trade is that by doing so they can get things they cannot produce themselves.

23. T If every country specializes in what it produces best, more goods will be produced than if each country tries to produce everything for its own needs.

24. F If a country has an absolute advantage in the production of all products then it makes no sense for it to trade with other countries.

25. F Almost all international trade is based on absolute advantage.

26. T Ricardo explained the law of comparative advantage on the basis of the labor theory of value.

27. F The concept of comparative advantage cannot be applied to sports.

28. T Comparative advantage is based on the opportunity costs of producing particular goods.

29. T World output will be maximized when each country produces according to its comparative advantage.

30. F The labor theory of value assumes that labor is only one of the relevant factors of production.

31. F Comparative advantage only applies to international trade.

32. F If the dollar cost of labor in a developing country is 50% less than in the U.S. and the productivity of that labor is equal to productivity in the U.S. than that labor is really more expensive than U.S. labor.

33. F If wages in Malaysia are lower than wages in the U.S., then it will cost less to produce virtually any product in Malaysia.

34. F A country with high wages cannot compete in world markets with countries where wages are low.

35. F A country should never produce a good in which it has a comparative advantage.

36. F A country should never export a product in which it has a comparative advantage.

37. F The dynamic gains from trade and the static gains from trade are the same thing.

38. F The static gains from trade are the gains a country receives over time.

39. T The dynamic gains from trade are especially important for small countries.

40. F Since the dynamic gains from trade cannot be quantified, they are relatively unimportant.

41. T An important dynamic gain from international trade is that trade tends to increase the rate of growth of real GDP.

42. T Free trade is a very effective way to increase the level of competition in the domestic market.

SHORT-ANSWER ESSAY

1. Suppose that the U.S. imports cloth from India. Describe what will happen to the price and quantity produced of cloth in both countries.

2. Briefly explain the doctrine of mercantilism.

3. What do football games and rats have to do with economic theory?

4. Show how a country could have an absolute disadvantage in the production of a product relative to another country and still have a comparative advantage in the production of the product.

5. Explain how trade will tend to emerge along the lines of comparative advantage.

6. List and explain the various dynamic gains from trade.