

Global Economic Analysis
Economics 3107 Fall 2009
 Dr. Leo H. Kahane

Midterm Exam #2 (A) – Answers (total possible points = 58)

Section I: Multiple Choice. Choose the best response, (2 points each).

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|------|------|
| 1. a | 5. c |
| 2. c | 6. c |
| 3. a | 7. b |
| 4. d | 8. b |

Section II: Identifications. In the space below, describe the following terms. (3 points each)

1. GATT – *General Agreement on Tariffs and Trade. Emerges just after World War II. Attempted to reduce protectionism worldwide and increase trade. Relies on nondiscrimination principle. Negotiations occur in ‘rounds’.*
2. NAFTA – *North American Free Trade Agreement. Created an RTA between U.S., Mexico and Canada.*
3. Greenfield FDI – *this is FDI where the home country establishes a brand new production facility that it fully owns in the foreign country.*
4. Dissemination risk – *risk associated with foreign market entry when a firm’s technical information (e.g. trade secrets) may ‘leak’ out. Subsidiary FDI or direct trade reduces this risk.*
5. Trade diversion – *occurs when the formation of an RTA leads to trade being diverted to a less efficient source.*
6. Rules of origin – *important for RTAs in determining the ‘origin’ of a product. For example, it may include a requirement that a certain proportion of a product’s components come from RTA members before considering the good as being ‘made’ by the RTA members.*
7. Most-favored-nation principle – *part of the ‘nondiscrimination’ principle of GATT/WTO. Any member of the GATT/WTO must treat all other members as generously as its most-favored trading partner.*
8. Strategic asset seeking – *a motivation for foreign market entry. A firm seeks to penetrate a market in order to get control of a strategic asset and thereby reduce competition (e.g. DeBeers and diamond mines).*

Section III: Consider the countries Argentina (A), Brazil (B) and Chile (C). Country A's price per bushel of potatoes (P^A) is \$5, whereas the price of country C's potatoes (P^C) is \$4 per bushel. Suppose country B currently has a specific tariff (t) of \$3 per bushel of imports of potatoes from either A or C. The graph below depicts the current scenario for country B:

a. Which country is the low-cost supplier of potatoes to county B? What will be the numerical value of imports from this low cost supplier assuming the tariff is in place? (3 points)

Low-cost supplier is C with $P^C + t = 7$; quantity of imports = 20 (value of imports = 140).

b. Suppose now country B forms a regional trade agreement (RTA) with A which eliminates the tariff between these two, but maintains the tariff on potatoes from country C. Which country is the source of imports for country B in this case? What will be the numerical value of imports in this case? (3 points)

Without tariff, county A is now the low-cost source with $P^A = 5$; quantity of imports = 40 (value of imports = 200).

c. Use the information in the graph to determine the numerical values for the change in consumer surplus (ΔCS), the change in producer surplus (ΔPS), the change in government tariff revenues ($\Delta \text{gov. rev.}$) and change in total surplus (ΔTS). Does the RTA increase or decrease total surplus from country B? Explain. (6 points) (Hint: the important areas to compute for this question are areas a, b, c, d and e shown.)

$$\Delta CS = (a+b+c+d) = 110+10+40+10 = 170$$

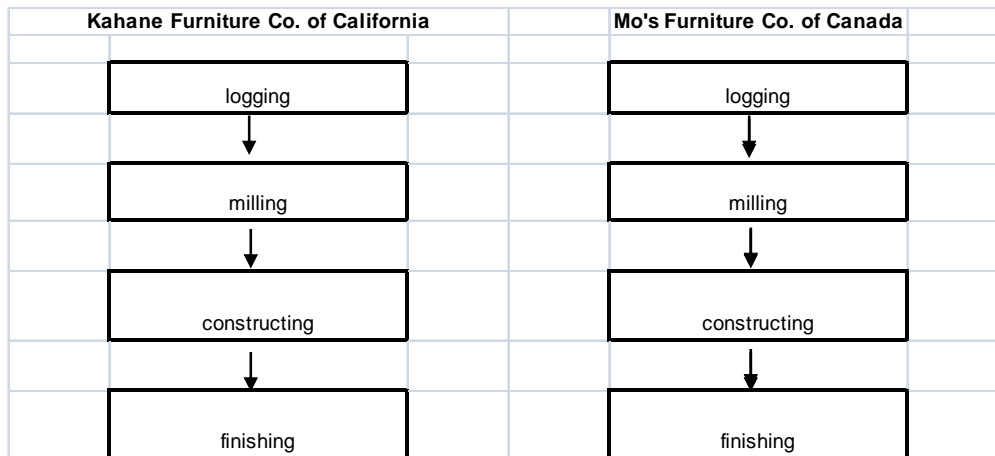
$$\Delta PS = -a = -110$$

$$\Delta \text{Government Revenue} = -(c+e) = -60$$

$$\Delta TS = 170 - 110 - 60 = 0$$

Therefore the RTAs trade creation effects exactly offset the trade diversion effects and total surplus is left unchanged.

Section IV: Consider the Kahane Furniture Company of California. They make furniture, starting from logging for wood through a series of steps to putting the finish on the product. There is a competing company in Canada, Mo's Furniture Company, which makes similar products. The figures below represent their value chains.



a. Suppose the Kahane Co. has a competitive advantage and is planning to penetrate the Canadian market via foreign direct investment with the acquisition of Mo's furniture company. Further, suppose that the cost of logging, milling and constructing is lower in the U.S. What would be the likely pattern of forward vertical integration? (That is, which steps would likely be done in the U.S. and which in Canada?). Explain. (3 points)

The only step done in Canada is 'finishing'.

b. Suppose now the Canadian government, due to a loss of jobs in the furniture building sector, decided to put a prohibitive tariff on the imports of constructed furniture. How would this likely change the pattern of forward vertical integration? Explain. (3 points)

Because of the tariff on constructed furniture, the U.S. will send milled wood to Canada for 'constructing' (thereby avoiding the tariff) and 'finishing'.