CHAPTER 13

INTERNATIONAL TRADE AND CAPITAL FLOWS

1. (C) **Mutual gains could be realized from trade if A specialized in food production and B specialized in drink production.**

   Explanation

   Mutual gains could be realized from trade if A specialized in food production and B specialized in drink production. The reason centers on comparative advantage. Country A must give up 7/9th unit of drink to produce one unit of food. Country B must give up 1 unit of drink to produce one unit of food. Therefore, the opportunity cost of producing food is greater for B than for A. If B produces 5 units of drink and A produces 9 units of food, total production will be greater than it would be if both countries produced both goods. By trading, both countries benefit.

   (Study Session 4, Module 13.1, LOS 13.c)

   Related Material

   Schweser Notes - Book 1

2. (A) **capital account.**

   Explanation:

   The capital account includes goods and financial assets that migrants bring when they come to country or take with them when they leave.

   (Study Session 4, Module 13.2, LOS 13.h)

   Related Material

   Schweser Notes - Book 1

3. (A) **specialize in goods for which they are the low opportunity cost producer.**

   Explanation

   The law of comparative advantage holds that trading partners can be made better off if they specialize in production of goods for which they are the low opportunity cost producer. They should export goods for which they have a comparative advantage and import goods for which their trading partners have a comparative advantage. The concept of comparative advantage compares costs of producing a good in terms of other goods a country might otherwise produce. Currency exchange rates are not relevant to the concept.

   (Study Session 4, Module 13.1, LOS 13.c)

   Related Material

   Schweser Notes - Book 1

4. (C) **increased revenue for the government.**

Explanation

Import quotas and voluntary export restraints, unlike tariffs, do not necessarily generate tax revenue. The other choices describe effects that result from tariffs, quotas, and VERB.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

5. (C) **private saving.**

Explanation

Other things equal, increasing savings would decrease a current account deficit, while increasing a government budget deficit or domestic investment would increase a current account deficit.

(Study Session 4, Module 13.2, LOS 13.i)

Related Material

Schweser Notes - Book 1

6. (C) **The costs of trade primarily affect those in domestic industries that compete with imports.**

Explanation

The benefits of trade are greater than the costs for the overall economy, but those in domestic industries competing with imports may suffer costs in the form of reduced profits or employment.

(Study Session 4, Module 13.1, LOS 13.b)

Related Material

Schweser Notes - Book 1

7. (C) **Trade with low-wage countries depresses wage rates in high-wage countries.**

Explanation

Trade with low-wage countries does not in itself depress wage rates since productivity must be considered. The other arguments have some support among economists.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

8. (C) **free trade area.**

Explanation

A free trade area removes barriers to trade among its members but does not require any of its members to change their trade policies with non-members. A common market and a customs union both impose uniformity on trade rules with non-member nations, which could restrict a member's low-cost imports from a nation that is not a member.

(Study Session 4, Module 13.2, LOS 13.f)

Related Material

Schweser Notes - Book 1

9. (A) **reduce the volatility of domestic asset prices.**

Explanation

Reasons commonly cited by governments for imposing capital restrictions include reducing the volatility of domestic asset prices, maintaining control of exchange rates, keeping domestic interest rates low, and protecting strategic industries from foreign ownership.

(Study Session 4, Module 13.2, LOS 13.g)

Related Material

Schweser Notes - Book 1

10. (C) **benefits the Japanese government and domestic producers.**

Explanation

The Japanese government's action is an example of a tariff A tariff is a tax imposed on imports and benefits the Japanese government because it collects the tariff. Domestic producers benefit because the reduction in the supply of imported goods means a higher domestic price.

The other choices are incorrect. A tariff is considered less harmful than a quota (an import quantity limitation) because under a quota, the domestic government does not receive any funds as it would under a tariff (the foreign producers receive the revenue transfer). In the long run, trade restrictions do not protect the net number of jobs in the country. The number of jobs protected by import restrictions will be offset by jobs lost in the import/export industry. Import/export firms will be unable to sell the overpriced domestic products abroad or import and sell the lower priced restricted foreign-made product.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

11. (C) **World Trade Organization.**

Explanation

The World Trade Organization (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably, and freely as possible.

(Study Session 4, Module 13.2, LOS 13.j)

Related Material

Schweser Notes - Book 1

12. (A) **Capital account.**

Explanation

The capital account consists of sales and purchases of non-produced, non-financial assets plus capital transfers.

(Study Session 4, Module 13.2, LOS 13.h)

Related Material

Schweser Notes - Book 1

13. (A) **only one is correct.**

Explanation

Forsythe is correct. A primary reason why trade restrictions remain widespread is the revenue that governments receive from tariffs. Novak is incorrect. Trade restrictions benefit specific groups, such as workers in the protected industries, but those benefits are most often less than the costs imposed on consumers and other industries as a whole.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

14. (A) **Domestic producers of the good.**

Explanation

Quotas restrict the supply of imported goods, which increases the price domestically, benefiting domestic producers but harming domestic consumers. While some specific foreign producers may also benefit from the higher prices created by the quota if they receive the revenue transfer (due to higher prices received for all goods sold under the import license), foreign producers as a whole are likely to experience decreased sales in the country that imposes a quota.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

15. (B) less than gross domestic product.

Explanation

GNP measures output produced by a country's citizens and capital owned by its citizens. GDP measures output produced within a country. In this example, production within the country (GDP) is greater than production by the country's citizens (GNP).

(Study Session 4, Module 13.1, LOS 13.a)

Related Material

Schweser Notes - Book 1

16. (C) Capital account surplus.

Explanation

If a country is running a current account deficit, it must have an inflow of foreign capital, creating a surplus in the capital account.

(Study Session 4, Module 13.2, LOS 13.h)

Related Material

Schweser Notes - Book 1

17. (C) Financial account.

Explanation

Government-owned assets abroad and foreign-owned assets in the country are sub-accounts of the financial account.

(Study Session 4, Module 13.2, LOS 13.h)

Related Material

Schweser Notes - Book 1

18. (C) industries competing with imported goods.

Explanation

Industries competing with imported goods may experience lower profit and employment due to international trade.

(Study Session 4, Module 13.1, LOS 13.b)

Related Material

Schweser Notes - Book 1

19. (A) Both nations can benefit from trade.

Explanation

Although one country may have an absolute advantage in all areas, trade is based on differences in opportunity costs, or comparative advantage. Any country will always have a comparative advantage in the production of some goods; thus, all countries can benefit from trade.

(Study Session 4, Module 13.1, LOS 13.c)

Related Material

Schweser Notes - Book 1

20. (A) **gross domestic product.**

Explanation

Gross domestic product measures the economic output produced within a country Gross national product includes output produced by citizens working abroad and output from foreign productive assets owned by a country's citizens and does not include output produced within a country by foreign workers or from productive assets in the domestic economy owned by foreigners. GDP includes production to replace physical capital as it wears out; national income does not.

(Study Session 4, Module 13.1, LOS 13.a)

Related Material

Schweser Notes - Book 1

21. (A) **by the amounts of labor and capital the countries possess.**

Explanation

In the Heckscher-Ohlin model a country that has relatively more capital will export capital-intensive goods and import labor-intensive goods, while a country that has relatively more labor will export labor-intensive goods and import capital-intensive goods. In the Ricardian model, differences in labor productivity are the source of comparative advantage.

(Study Session 4, Module 13.1, LOS 13.d)

Related Material

Schweser Notes - Book 1

22. (C) **Trucking companies.**

Explanation

Tariffs on transportation equipment benefit the government in the form of tariff revenue, and benefit domestic producers and industry workers in the form of higher prices for transportation equipment. The users of transportation equipment, such as trucking companies, suffer from higher costs due to the higher prices of transportation equipment.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

23. (A) **Keep domestic interest rates high.**

Explanation

A common objective of capital restrictions is to keep domestic interest rates low (not high), by eliminating competition by other countries for investor funds. The other two choices are common objectives of capital restrictions.

(Study Session 4, Module 13.2, LOS 13.g)

Related Material

Schweser Notes - Book 1

24. (A) impose capital restrictions.

Explanation

Objectives commonly cited for imposing capital restrictions include reducing the volatility of domestic asset prices, protecting domestic industries, maintaining fixed exchange rates, and keeping domestic interest rates low.

(Study Session 4, Module 13.2, LOS 13.g) Related Material

Related Material

Schweser Notes - Book 1

25. (C) both Country P and Country Q.

Explanation

Both countries in an international trade relationship benefit in the long run. Costs of international trade tend to be short-run effects in specific domestic industries.

(Study Session 4, Module 13.1, LOS 13.b)

Related Material

Schweser Notes - Book 1

26. (B) gross national product, but not gross domestic product.

Explanation

Gross domestic product includes the total value of goods and services produced within a country's borders. The income of a country's citizens working abroad is included in its GNP but not in its GDP.

(Study Session 4, Module 13.1, LOS 13.a)

Related Material

Schweser Notes - Book 1

27. (A) a comparative advantage only.

Explanation

A country is said to have a comparative advantage in the production of a good if its opportunity cost, in terms of other goods that could be produced instead, is lower than that of another country. A country can have a comparative advantage in producing a good even if its trading partner has an absolute advantage in producing that good.

(Study Session 4, Module 13.1, LOS 13.c)

Related Material

Schweser Notes - Book 1

28. (A) prohibits foreign firms from selling products below cost to gain market share.

Explanation

Firms dump their goods at a price lower than cost in order to drive out the competition. Once this is complete, they will be able to raise prices to much higher levels in order to gain abnormal profits. Of course, once prices are increased, new competitors may arise.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

29. (C) current account and financial account.

Explanation

According to the U.S. Federal Reserve, "The BOP [balance of payments] includes the current account, which mainly measures the flows of goods and services; the capital account, which consists of capital transfers and the acquisition and disposal of non- produced, non-financial assets; and the financial account, which records investment flows."

(Study Session 4, Module 13.2, LOS 13.h)

Related Material

Schweser Notes - Book 1

30. (C) protect industries in which they have a comparative advantage.

Explanation

If a particular country enjoys a comparative advantage in a particular industry, no protection is needed.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

31. (C) economic union.

Explanation

The two countries are a part of an economic union. In an economic union, there is (1) free trade among members, (2) common restrictions (tariffs) on imports from non-members, (3) free movement of production factors (labor), and (4) common economic institutions and coordination of economic policies. While a customs union has common tariffs on imports from non-union countries and free trade, it does not allow workers to cross the borders freely and does not have common economic institutions. A monetary union requires all of the listed items and a common currency.

(Study Session 4, Module 13.2, LOS 13.f)

Related Material

Schweser Notes - Book 1

32. (B) Domestic consumers.

Explanation

Domestic consumers in the country that imposes a tariff are harmed because they must pay higher prices for the good. Tariffs benefit domestic producers of the good by effectively imposing a price increase on competing imports. A tariff does not affect foreign consumers of the good.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

33. (A) Both countries would gain if Germany traded beer for Holland's cheese.

Explanation

Germany has an absolute advantage in both beer and cheese because it can produce more of both per unit of labor input than Holland. The opportunity cost of producing beer is 5/10 = 0.5 in Germany and 4/6 = 0.67 in Holland. The opportunity cost of producing cheese is 10/5 = 2 in Germany and 6/4 = 1.5 in Holland. Holland has a comparative advantage in producing cheese and Germany has a comparative advantage in producing beer. Both countries can gain if Germany trades beer for Holland's cheese.

(Study Session 4, Module 13.1, LOS 13.c)

Related Material

Schweser Notes - Book 1

34. (B) relative scarcity of labor and capital.

Explanation

In the Heckscher-Ohlin model of trade, the source of comparative advantage is the relative scarcity of labor and capital in each country.

(Study Session 4, Module 13.1, LOS 13.d)

Related Material

Schweser Notes - Book 1

35. (C) relative amounts of labor and capital.

Explanation

In the Heckscher-Ohlin model, the source of comparative advantage is the relative amounts of labor and capital that are available in each country. Countries with more capital available relative to labor available will have a comparative advantage in producing capital-intensive goods, while countries with more labor available relative to capital will have a comparative advantage in labor-intensive goods.

For Further Reference:

(Study Session 4, Module 13.1, LOS 13.d)

CFA® Program Curriculum, Volume 2, page 360

Related Material

Schweser Notes - Book 1

36. (C) as a tax on imports, and a quota limits the quantity that can be imported.

Explanation

The difference between a tariff and a quota is that a tariff is a tax imposed on imported goods, while a quota is an import quantity limitation. Both are imposed by individual countries.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

37. (A) Capital account.

Explanation

Capital transfers and sales of non-financial assets are sub-accounts of the capital account.

(Study Session 4, Module 13.2, LOS 13.h)

Related Material

Schweser Notes - Book 1

38. (B) set of economic policies.

Explanation

An economic union is a common market that has also adopted common institutions and economic policy. Both common markets and economic unions adopt a common set of trade restrictions with non-members. Neither requires the adoption of a common currency, which is a characteristic of a monetary union.

(Study Session 4, Module 13.2, LOS 13.f)

Related Material

Schweser Notes - Book 1

39. (B) labor productivity.

Explanation

The Ricardian model of trade only considers labor as a factor of production. Comparative advantage results from differences in labor productivity. Labor and capital inputs are both considered in the Heckscher-Ohlin model of trade.

(Study Session 4, Module 13.1, LOS 13.d)

Related Material

Schweser Notes - Book 1

40. (A) promoting exchange rate stability.

Explanation

The primary goals of the IMF are to promote international monetary cooperation, facilitate growth of international trade, promote exchange rate stability, assist in establishing a multilateral payment system, and provide resources to members with balance of payments difficulties. Reducing global poverty is a role of the World Bank. Resolving trade disputes is a role of the World Trade Organization.

(Study Session 4, Module 13.2, LOS 13.j)

Related Material

Schweser Notes - Book 1

41. (C) a good at a lower opportunity cost than another nation.

Explanation

A nation has a comparative advantage in producing a good when its opportunity cost of producing that good, in terms of other goods it could produce, is lower compared to another country.

(Study Session 4, Module 13.1, LOS 13.c)

Related Material

Schweser Notes - Book 1

42. (B) International Monetary Fund.

Explanation

The IMF's main goals are promoting international monetary cooperation; facilitating the expansion and balanced growth of international trade; promoting exchange stability; assisting in the establishment of a multilateral system of payments; and making resources available (with adequate safeguards) to members.

(Study Session 4, Module 13.2, LOS 13.j)

Related Material

Schweser Notes - Book 1

43. (A) domestic capital invested abroad.

Explanation

GNP includes goods and services produced outside the country by domestic factors of production, both labor and capital.

(Study Session 4, Module 13.1, LOS 13.a)

Related Material

Schweser Notes - Book 1

44. (A) cloth.

Explanation

To produce a unit of cloth, Country A must give up 4/14 = 0.29 units of corn, while Country B must give up 8/16 = 0.50 units of corn. Therefore Country A has a comparative advantage (i.e., a lower opportunity cost) in producing cloth.

To produce a unit of corn, Country A must give up 14/4 = 3.5 units of cloth, while Country B must give up 16/8 = 2.0 units of cloth. Therefore Country B has a comparative advantage in producing corn.

Note that this question gives output per unit of labor. In other questions you may see labor hours per unit of output. For this question that would be 1/14 units of labor per unit of cloth and 1/4 unit of labor per unit of corn for Country A, and 1/16 unit of labor per unit of corn and 1/8 unit of labor per unit of cloth for Country B. No matter how the data are presented, just focus on the trade-off, what each country must give up of one good to produce one unit of the other good.

(Study Session 4, Module 13.1, LOS 13.c)

Related Material

Schweser Notes - Book 1

45. (C) Customs union.

Explanation

Economic unions and common markets remove all barriers to the movement of labor and capital among their members. Customs unions do not have this feature.

(Study Session 4, Module 13.2, LOS 13.f)

Related Material

Schweser Notes - Book 1

46. (C) reducing poverty is the World Bank.

Explanation

The World Bank has the explicit mission of fighting poverty. Both the WTO and IMF work to expand international trade. Both the World Bank and IMF provide funds to member nations, the World Bank for development and the IMF when member nations experience balance of payments difficulties.

(Study Session 4, Module 13.2, LOS 13.j)

Related Material

Schweser Notes - Book 1

47. (B) total domestic savings are greater than domestic investment.

Explanation

The relationship between saving, investment, and the trade deficit can be expressed as: (exports - imports) = private savings + government savings – investment with a current account surplus (exports > imports), total domestic savings (the sum of private savings and government savings) are greater than domestic investment.

(Study Session 4, Module 13.2, LOS 13.i)

Related Material

Schweser Notes - Book 1

48. (C) monetary union.

Explanation

A monetary union, such as the Euro zone, is the most integrated type of trading bloc or regional trade agreement because the members adopt a common currency.

(Study Session 4, Module 13.2, LOS 13.f)

Related Material

Schweser Notes - Book 1

49. (B) current account deficit.

Explanation

A country that has imports valued more than its exports is said to have a current account (trade) deficit, while countries with more exports than imports are said to have a current account surplus.

(Study Session 4, Module 13.2, LOS 13.h)

Related Material

Schweser Notes - Book 1

50. (A) Current account.

Explanation

Merchandise and services, income receipts, and unilateral transfers are sub-accounts of the current account.

(Study Session 4, Module 13.2, LOS 13.h)

Related Material

Schweser Notes - Book 1

51. (B) a nation will benefit from trade when it imports goods for which it is the high cost producer and exports goods for which it is the low-cost producer.

Explanation

This statement is the law of comparative advantage.

The other choices are incorrect. The law of comparative advantage supports international trade. According to the law of comparative advantage, both trading partners are better off if they specialize in the production of goods for which they are the low-opportunity cost producer and trade for those goods for which they are the high-opportunity cost producer. Mexico is considered to have an absolute advantage in plastics if Mexico can produce plastic using fewer resources than the U.S.

(Study Session 4, Module 13.1, LOS 13.c)

Related Material

Schweser Notes - Book 1

52. (A) Domestic consumers.

Explanation

A tax imposed on imports is called a tariff, which benefits domestic producers and domestic governments. Domestic consumers lose through higher prices, less choice of products, and lower quality products.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

53. (C) **domestic investment decreases.**

Explanation

The relation between the trade deficit (the current account), savings (both private and government) and domestic investments is stated as (X - M) = private savings + government savings - investment. A current account deficit will tend to narrow if private savings increase, government savings increase (either taxes increase or government spending decreases), or domestic investment decreases.

(Study Session 4, Module 13.2, LOS 13.i)

Related Material

Schweser Notes - Book 1

54. (B) **quotas.**

Explanation

Quotas are limits on the amounts of imports allowed into a country in a period of time. Government payments to firms that export goods are known as export subsidies. Taxes on imported goods collected by the government are known as tariffs.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

55. (C) **domestic suppliers of goods protected by tariffs.**

Explanation

Tariffs raise domestic prices, benefiting domestic suppliers.

(Study Session 4, Module 13.2, LOS 13.e)

Related Material

Schweser Notes - Book 1

56. (C) **Mutual gains could be realized from trade if A specialized in drink production and B specialized in the food production.**

Explanation

Mutual gains could be realized from trade if A specialized in drink production and B specialized in food production. The reason centers on comparative advantage. Country A must give up 1.5 units of drink to produce one unit of food. Country B must give up 0.875 units of drink to produce one unit of food. Therefore, the opportunity cost of producing food is greater for A than for B. If B produces 8 units of food and A produces 6 units of drink, total production will be greater than it would be if both countries produced both goods. By trading, both countries benefit.

(Study Session 4, Module 13.1, LOS 13.c)

Related Material

Schweser Notes - Book 1

57. (C) Customs union, economic union, monetary union.

Explanation

The order by degree of economic integration (from least to most integrated) is as follows: free trade areas, customs union, common market, economic union, and monetary union.

(Study Session 4, Module 13.2, LOS 13.f)

Related Material

Schweser Notes - Book 1

58. (A) improve economic welfare for their members.

Explanation

The primary reason countries join regional trade agreements is to improve economic welfare by reducing or eliminating trade restrictions.

(Study Session 4, Module 13.2, LOS 13.f)

Related Material

Schweser Notes - Book 1