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CHAPTER 2—FOUNDATIONS OF MODERN TRADE THEORY: COMPARATIVE ADVANTAGE

MULTIPLE CHOICE

1. The mercantilists would have objected to:
   a. Export promotion policies initiated by the government
   b. The use of tariffs or quotas to restrict imports
   c. Trade policies designed to accumulate gold and other precious metals
   d. International trade based on open markets

   ANS: D PTS: 1

2. Unlike the mercantilists, Adam Smith maintained that:
   a. Trade benefits one nation only at the expense of another nation
   b. Government control of trade leads to maximum economic welfare
   c. All nations can gain from free international trade
   d. The world's output of goods must remain constant over time

   ANS: C PTS: 1

3. The trading principle formulated by Adam Smith maintained that:
   a. International prices are determined from the demand side of the market
   b. Differences in resource endowments determine comparative advantage
   c. Differences in income levels govern world trade patterns
   d. Absolute cost differences determine the immediate basis for trade

   ANS: D PTS: 1

4. Unlike Adam Smith, David Ricardo's trading principle emphasizes the:
   a. Demand side of the market
   b. Supply side of the market
   c. Role of comparative costs

d. Role of absolute costs

ANS: C PTS: 1

5. When a nation requires fewer resources than another nation to produce a product, the nation is said to have a:
a. Absolute advantage in the production of the product
b. Comparative advantage in the production of the product
c. Lower marginal rate of transformation for the product
d. Lower opportunity cost of producing the product

ANS: A PTS: 1

6. According to the principle of comparative advantage, specialization and trade increase a nation's total output since:
a. Resources are directed to their highest productivity
b. The output of the nation's trading partner declines
c. The nation can produce outside of its production possibilities curve
d. The problem of unemployment is eliminated

ANS: A PTS: 1

7. In a two-product, two-country world, international trade can lead to increases in:
a. Consumer welfare only if output of both products is increased
b. Output of both products and consumer welfare in both countries
c. Total production of both products, but not consumer welfare in both countries
d. Consumer welfare in both countries, but not total production of both products

ANS: B PTS: 1

8. As a result of international trade, specialization in production tends to be:
a. Complete with constant costs--complete with increasing costs
b. Complete with constant costs--incomplete with increasing costs
c. Incomplete with constant costs--complete with increasing costs
d. Incomplete with constant costs--incomplete with increasing costs

ANS: B PTS: 1

9. A nation that gains from trade will find its consumption point being located:
a. Inside its production possibilities curve
b. Along its production possibilities curve
c. Outside its production possibilities curve
d. None of the above

ANS: C PTS: 1

Table 2.1. Output Possibilities of the U.S. and the U.K.

	Output per Worker per day	
Country	Tons of Steel	Televisions
United States	5	45
United Kingdom	10	20

10. Referring to Table 2.1, the United States has the absolute advantage in the production of:
    a. Steel
    b. Televisions
    c. Both steel and televisions
    d. Neither steel nor televisions

    ANS: C PTS: 1

11. Referring to Table 2.1, the United Kingdom has a comparative advantage in the production of:
    a. Steel
    b. Televisions
    c. Both steel and televisions
    d. Neither steel nor televisions

    ANS: A PTS: 1

12. Refer to Table 2.1. If trade opens up between the United States and the United Kingdom, American firms should specialize in producing:
    a. Steel
    b. Televisions
    c. Both steel and televisions
    d. Neither steel nor televisions

    ANS: B PTS: 1

13. Referring to Table 2.1, the opportunity cost of producing one ton of steel in the United States is:
    a. 3 televisions
    b. 10 televisions
    c. 20 televisions
    d. 45 televisions

    ANS: A PTS: 1

14. Refer to Table 2.1. Mutually advantageous trade will occur between the United States and the United Kingdom so long as one ton of steel trades for:
    a. At least 1 television, but no more than 2 televisions
    b. At least 2 televisions, but no more than 3 televisions
    c. At least 3 televisions, but no more than 4 televisions
    d. At least 4 televisions, but no more than 5 televisions

    ANS: B PTS: 1

15. Referring to Table 2.1, the United Kingdom gains most from trade if:

a. 1 ton of steel trades for 2 televisions
b. 1 ton of steel trades for 3 televisions
c. 2 tons of steel trade for 4 televisions
d. 2 tons of steel trade for 5 televisions

ANS: B PTS: 1

16. Concerning international trade restrictions, which of the following is false? Trade restrictions:
a. Limit specialization and the division of labor
b. Reduce the volume of trade and the gains from trade
c. Cause nations to produce inside their production possibilities curves
d. May result in a country producing some of the product of its comparative disadvantage

ANS: C PTS: 1

17. If a production possibilities curve is bowed out (i.e., concave) in appearance, production occurs under conditions of:
a. Constant opportunity costs
b. Increasing opportunity costs
c. Decreasing opportunity costs
d. Zero opportunity costs

ANS: B PTS: 1

18. Increasing opportunity costs suggest that:
a. Resources are not perfectly shiftable between the production of two goods
b. Resources are fully shiftable between the production of two goods
c. A country's production possibilities curve appears as a straight line
d. A country's production possibilities curve is bowed inward (i.e., convex) in appearance

ANS: A PTS: 1

19. The trading-triangle concept is used to indicate a nation's:
a. Exports, marginal rate of transformation, terms of trade
b. Imports, terms of trade, marginal rate of transformation
c. Marginal rate of transformation, imports, exports
d. Terms of trade, exports, imports

ANS: D PTS: 1

20. Assuming increasing cost conditions, trade between two countries would not be likely if they have:
a. Identical demand conditions but different supply conditions
b. Identical supply conditions but different demand conditions
c. Different supply conditions and different demand conditions
d. Identical demand conditions and identical supply conditions

ANS: D PTS: 1

Table 2.2. Output possibilities for South Korea and Japan

	Output per worker per day	
Country	Tons of steel	VCRs
South Korea	80	40
Japan	20	20

21. Referring to Table 2.2, the opportunity cost of one VCR in Japan is:
    a. 1 ton of steel
    b. 2 tons of steel
    c. 3 tons of steel
    d. 4 tons of steel

    ANS: A PTS: 1

22. Referring to Table 2.2, the opportunity cost of one VCR in South Korea is:
    a. 1/2 ton of steel
    b. 1 ton of steel
    c. 1 1/2 tons of steel
    d. 2 tons of steel

    ANS: D PTS: 1

23. Refer to Table 2.2. According to the principle of absolute advantage, Japan should:
    a. Export steel
    b. Export VCRs
    c. Export steel and VCRs
    d. None of the above; there is no basis for gainful trade

    ANS: D PTS: 1

24. Refer to Table 2.2. According to the principle of comparative advantage:
    a. South Korea should export steel
    b. South Korea should export steel and VCRs
    c. Japan should export steel
    d. Japan should export steel and VCRs

    ANS: A PTS: 1

25. Refer to Table 2.2. With international trade, what would be the maximum amount of steel that South Korea would be willing to export to Japan in exchange for each VCR?
    a. 1/2 ton of steel
    b. 1 ton of steel
    c. 1-1/2 tons of steel
    d. 2 tons of steel

    ANS: D PTS: 1

26. Refer to Table 2.2. With international trade, what would be the maximum number of VCRs that Japan would be willing to export to South Korea in exchange for each ton of steel?
    a. 1 VCR
    b. 2 VCRs
    c. 3 VCRs
    d. 4 VCRs

    ANS: A PTS: 1

27. The earliest statement of the principle of comparative advantage is associated with:

a. Adam Smith
b. David Ricardo
c. Eli Heckscher
d. Bertil Ohlin

ANS: B PTS: 1

28. If Hong Kong and Taiwan had identical labor costs but were subject to increasing costs of production:
a. Trade would depend on differences in demand conditions
b. Trade would depend on economies of large-scale production
c. Trade would depend on the use of different currencies
d. There would be no basis for gainful trade

ANS: A PTS: 1

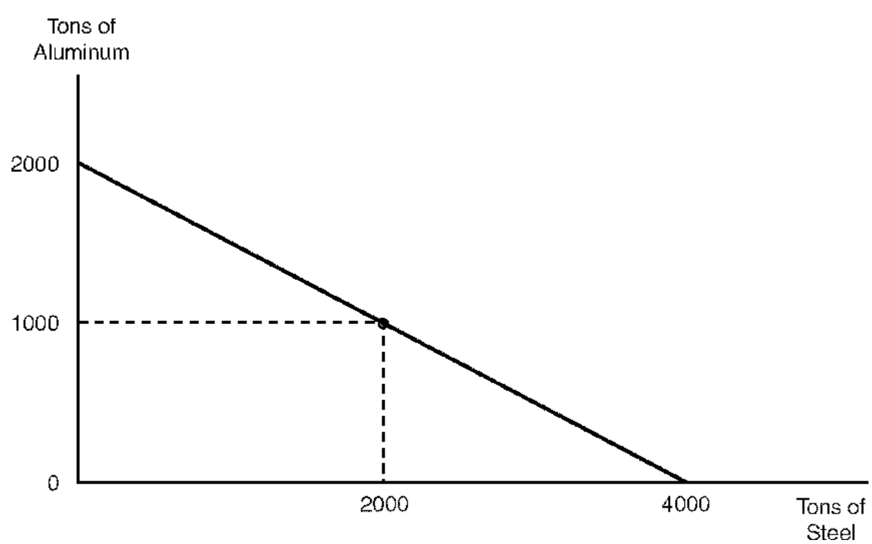
29. If the international terms of trade settle at a level that is between each country's opportunity cost:
a. There is no basis for gainful trade for either country
b. Both countries gain from trade
c. Only one country gains from trade
d. One country gains and the other country loses from trade

ANS: B PTS: 1

30. International trade is based on the notion that:
a. Different currencies are an obstacle to international trade
b. Goods are more mobile internationally than are resources
c. Resources are more mobile internationally than are goods
d. A country's exports should always exceed its imports

ANS: B PTS: 1

Figure 2.1. Production Possibilities Schedule



31. Referring to Figure 2.1, the relative cost of steel in terms of aluminum is:
a. 4.0 tons
b. 2.0 tons

c. 0.5 tons
d. 0.25 tons

ANS: C PTS: 1

32. Referring to Figure 2.1, the relative cost of aluminum in terms of steel is:
a. 4.0 tons
b. 2.0 tons
c. 0.5 tons
d. 0.25 tons

ANS: B PTS: 1

33. Refer to Figure 2.1. If the relative cost of steel were to rise, then the production possibilities schedule would:
a. Become steeper
b. Become flatter
c. Shift inward in a parallel manner
d. Shift outward in a parallel manner

ANS: A PTS: 1

34. Refer to Figure 2.1. If the relative cost of aluminum were to rise, then the production possibilities schedule would:
a. Become steeper
b. Become flatter
c. Shift inward in a parallel manner
d. Shift outward in a parallel manner

ANS: B PTS: 1

35. When a nation achieves autarky equilibrium:
a. Input price equals final product price
b. Labor productivity equals the wage rate
c. Imports equal exports
d. Production equals consumption

ANS: D PTS: 1

36. When a nation is in autarky and maximizes its living standard, its consumption and production points are:
a. Along the production possibilities schedule
b. Above the production possibilities schedule
c. Beneath the production possibilities schedule
d. Any of the above

ANS: A PTS: 1

37. If Canada experiences increasing opportunity costs, its supply schedule of steel will be:
    a. Downward-sloping
    b. Upward-sloping
    c. Horizontal
    d. Vertical

    ANS: B PTS: 1

38. If Canada experiences constant opportunity costs, its supply schedule of steel will be:
    a. Downward-sloping
    b. Upward-sloping
    c. Horizontal
    d. Vertical

    ANS: C PTS: 1

39. The gains from international trade increase as:
    a. A nation consumes inside of its production possibilities schedule
    b. A nation consumes along its production possibilities schedule
    c. The international terms of trade rises above the nation's autarky price
    d. The international terms of trade approaches the nation's autarky price

    ANS: C PTS: 1

40. In a two-country, two-product world, the statement "Japan enjoys a comparative advantage over France in steel relative to bicycles" is equivalent to:
    a. France having a comparative advantage over Japan in bicycles relative to steel
    b. France having a comparative disadvantage against Japan in bicycles and steel
    c. Japan having a comparative advantage over France in steel and bicycles
    d. Japan having a comparative disadvantage against Japan in bicycles and steel

    ANS: A PTS: 1

41. Ricardo's theory of comparative advantage was of limited real-world validity because it was founded on the:
    a. Labor theory of value
    b. Capital theory of value
    c. Land theory of value
    d. Entrepreneur theory of value

    ANS: A PTS: 1

42. Assume that labor is the only factor of production and that wages in the United States equal $20 per hour while wages in the United Kingdom equal $10 per hour. Production costs would be lower in the United States than the United Kingdom if:
    a. U.S. labor productivity equaled 40 units per hour while U.K. labor productivity equaled 15 units per hour
    b. U.S. labor productivity equaled 30 units per hour while U.K. labor productivity equaled 20 units per hour
    c. U.S. labor productivity equaled 20 units per hour while U.K. labor productivity equaled 30 units per hour
    d. U.S. labor productivity equaled 15 units per hour while U.K. labor productivity equaled 25 units per hour

ANS: A PTS: 1

43. According to Ricardo, a country will have a comparative advantage in the product in which its:
    a. Labor productivity is relatively low
    b. Labor productivity is relatively high
    c. Labor mobility is relatively low
    d. Labor mobility is relatively high

ANS: B PTS: 1

44. The Ricardian model of comparative advantage is based on all of the following assumptions except:
    a. Only two nations and two products
    b. Product quality varies among nations
    c. Labor is the only factor of production
    d. Labor can move freely within a nation

ANS: B PTS: 1

45. The writings of G. MacDougall emphasized which of the following as an explanation of a country's competitive position?
    a. National income levels
    b. Relative endowments of natural resources
    c. Domestic tastes and preferences
    d. Labor compensation and productivity levels

ANS: D PTS: 1

46. The introduction of community indifference curves into our trading example focuses attention on the nation's:
    a. Income level
    b. Resource prices
    c. Tastes and preferences
    d. Productivity level

ANS: C PTS: 1

47. Introducing indifference curves into our trade model permits us to determine:
    a. Where a nation chooses to locate along its production possibilities curve in autarky
    b. The precise location of a nation's production possibilities curve
    c. Whether absolute cost or comparative cost conditions exist
    d. The currency price of one product in terms of another product

ANS: A PTS: 1

48. In the absence of trade, a nation is in equilibrium where a community indifference curve:
    a. Lies above its production possibilities curve
    b. Is tangent to its production possibilities curve
    c. Intersects its production possibilities curve
    d. Lies below its production possibilities curve

ANS: B PTS: 1

49. The use of indifference curves helps us determine the point:
    a. Along the terms-of-trade line a country will choose

b. Where a country maximizes its resource productivity
c. At which a country ceases to become competitive
d. Where the marginal rate of transformation approaches zero

ANS: A PTS: 1

50. With trade, a country will <u>maximize</u> its satisfaction when it:
a. Moves to the highest possible indifference curve
b. Forces the marginal rate of substitution to its lowest possible value
c. Consumes more of both goods than it does in autarky
d. Finds its marginal rate of substitution exceeding its marginal rate of transformation

ANS: A PTS: 1

51. Trade between two nations would <u>not</u> be possible if they have:
a. Identical community indifference curves but different production possibilities curves
b. Identical production possibilities curves but different community indifference curves
c. Different production possibilities curves and different community indifference curves
d. Identical production possibilities curves and identical community indifference curves

ANS: D PTS: 1

52. Given a two-country and two-product world, the United States would enjoy <u>all</u> the attainable gains from free trade with Canada if it:
a. Trades at the U.S. rate of transformation
b. Trades at the Canadian rate of transformation
c. Specializes completely in the production of both goods
d. Specializes partially in the production of both goods

ANS: B PTS: 1

53. John Stuart Mill's theory of reciprocal demand best applies when trading partners:
a. Are of equal size and importance in the market
b. Produce under increasing cost conditions
c. Partially specialize in the production of commodities
d. Have similar taste and preference levels

ANS: A PTS: 1

54. The equilibrium prices and quantities established after trade are <u>fully</u> determinate if we know:
a. The location of all countries' indifference curves
b. The shape of each country's production possibilities curve
c. The comparative costs of each trading partner
d. The strength of world supply and demand for each good

ANS: D PTS: 1

55. "The equilibrium relative commodity price at which trade takes place is determined by the conditions of demand and supply for each commodity in both nations. Other things being equal, the nation with the more intense demand for the other nation's exported good will gain less from trade than the nation with the less intense demand." This statement was first proposed by:
a. Alfred Marshall with offer curve analysis
b. John Stuart Mill with the theory of reciprocal demand
c. Adam Smith with the theory of absolute advantage

d. David Ricardo with the theory of comparative advantage

ANS: B PTS: 1

56. Which of the following terms-of-trade concepts is calculated by dividing the change in a country's export price index by the change in its import price index between two points in time, multiplied by 100 to express the terms of trade in percentages?
a. Commodity terms of trade
b. Marginal rate of transformation
c. Marginal rate of substitution
d. Autarky price ratio

ANS: A PTS: 1

57. The best explanation of the gains from trade that David Ricardo could provide was to describe only the outer limits within which the equilibrium terms of trade would fall. This is because Ricardo's theory did <u>not</u> recognize how market prices are influenced by:
a. Demand conditions
b. Supply conditions
c. Business expectations
d. Profit patterns

ANS: A PTS: 1

58. Under free trade, Sweden enjoys all of the gains from trade with Holland if Sweden:
a. Trades at Holland's rate of transformation
b. Trades at Sweden's rate of transformation
c. Specializes completely in the production of its export good
d. Specializes partially in the production of its export good

ANS: A PTS: 1

59. Because the Ricardian trade theory recognized only how supply conditions influence international prices, it could determine:
a. The equilibrium terms of trade
b. The outer limits for the terms of trade
c. Where a country chooses to locate along its production possibilities curve
d. Where a country chooses to locate along its trade triangle

ANS: B PTS: 1

60. The terms of trade is given by the prices:
a. Paid for all goods imported by the home country
b. Received for all goods exported by the home country
c. Received for exports and paid for imports
d. Of primary products as opposed to manufactured products

ANS: C PTS: 1

Table 2.3. Terms of Trade

Export Price Index		Import Price Index		
Country	1990	2004	1990	2004
Mexico	100	220	100	200

Sweden	100	160	100	150
Spain	100	155	100	155
France	100	170	100	230
Denmark	100	120	100	125

61. Referring to Table 2.3, which countries' terms of trade improved between 1990 and 2004?
    a. Mexico and Denmark
    b. Sweden and Denmark
    c. Sweden and Spain
    d. Mexico and Sweden

    ANS: D PTS: 1

62. Referring to Table 2.3, which countries' terms of trade worsened between 1990 and 2004?
    a. Spain and Mexico
    b. Mexico and France
    c. France and Denmark
    d. Denmark and Sweden

    ANS: C PTS: 1

63. Referring to Table 2.3, which country's terms of trade did not change between 1990 and 2004?
    a. Spain
    b. Sweden
    c. France
    d. Denmark

    ANS: A PTS: 1

64. Given free trade, small nations tend to benefit the most from trade since they:
    a. Are more productive than their large trading partners
    b. Are less productive than their large trading partners
    c. Have demand preferences and income levels lower than their large trading partners
    d. Enjoy terms of trade lying near the opportunity costs of their large trading partners

    ANS: D PTS: 1

65. A terms-of-trade index that equals 150 indicates that compared to the base year:
    a. It requires a greater output of domestic goods to obtain the same amount of foreign goods
    b. It requires a lesser amount of domestic goods to obtain the same amount of foreign goods
    c. The price of exports has risen from $100 to $150
    d. The price of imports has risen from $100 to $150

    ANS: B PTS: 1

66. A term-of-trade index that equals 90 indicates that compared to the base year:
    a. It requires a greater output of domestic goods to obtain the same amount of foreign goods
    b. It requires a lesser amount of domestic goods to obtain the same amount of foreign goods
    c. The price of exports has fallen from $100 to $90
    d. The price of imports has fallen from $100 to $90

    ANS: A PTS: 1

67. The theory of reciprocal demand does not well apply when one country:

a. Produces under constant cost conditions
b. Produces along its production possibilities curve
c. Is of minor economic importance in the world marketplace
d. Partially specializes the production of its export good

ANS: C PTS: 1

68. The terms of trade is given by:
a. (Price of exports/price of imports) – 100
b. (Price of exports/price of imports) + 100
c. (Price of exports/price of imports) ÷ 100
d. (Price of exports/price of imports) × 100

ANS: D PTS: 1

69. If Japan and France have identical production possibilities curves and identical community indifference curves:
a. Japan will enjoy all the gains from trade
b. France will enjoy all the gains from trade
c. Japan and France share equally in the gains from trade
d. Gainful specialization and trade are not possible

ANS: D PTS: 1

70. A rise in the price of imports or a fall in the price of exports will:
a. Improve the terms of trade
b. Worsen the terms of trade
c. Expand the production possibilities curve
d. Contract the production possibilities curve

ANS: B PTS: 1

71. A fall in the price of imports or a rise in the price of exports will:
a. Improve the terms of trade
b. Worsen the terms of trade
c. Expand the production possibilities curve
d. Contract the production possibilities curve

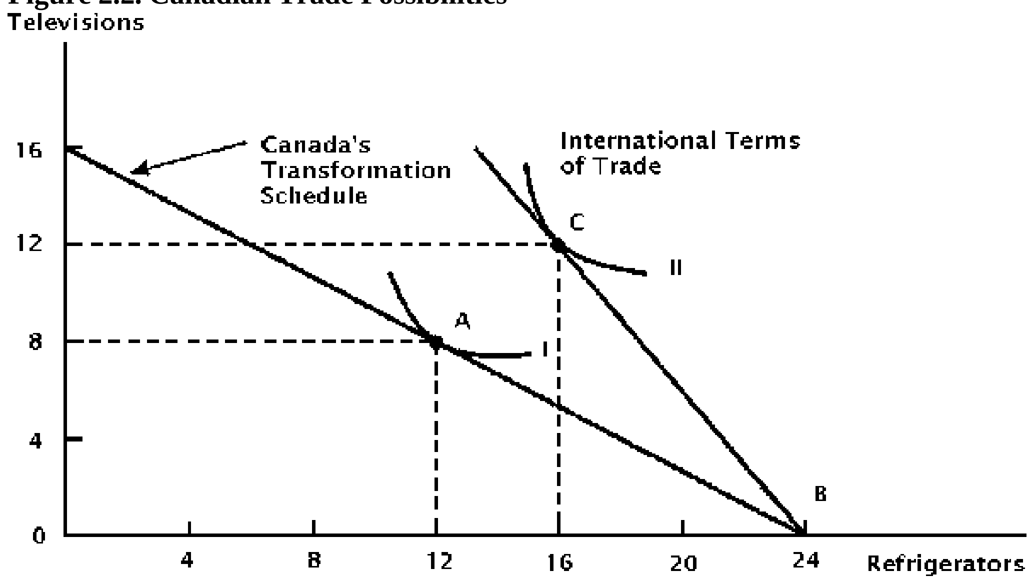
ANS: A PTS: 1

72. Under free trade, Canada would <u>not</u> enjoy any gains from trade with Sweden if Canada:
a. Trades at the Canadian rate of transformation
b. Trades at Sweden's rate of transformation
c. Specializes completely in the production of its export good
d. Specializes partially in the production of its export good

ANS: A PTS: 1

Figure 2.2 illustrates trade data for Canada. The figure assumes that Canada attains international trade equilibrium at point C.

Figure 2.2. Canadian Trade Possibilities



73. Consider Figure 2.2. In the absence of trade, Canada would produce and consume:
    a. 8 televisions and 16 refrigerators
    b. 12 televisions and 16 refrigerators
    c. 8 televisions and 12 refrigerators
    d. 12 televisions and 8 refrigerators

    ANS: C PTS: 1

74. Referring to Figure 2.2, Canada has a comparative advantage in:
    a. Televisions
    b. Refrigerators
    c. Televisions and refrigerators
    d. Neither televisions nor refrigerators

    ANS: B PTS: 1

75. Consider Figure 2.2. With specialization, Canada produces:
    a. 16 televisions
    b. 12 televisions and 8 refrigerators
    c. 8 televisions and 16 refrigerators
    d. 24 refrigerators

    ANS: D PTS: 1

76. Consider Figure 2.2. With trade, Canada consumes:
    a. 12 televisions and 8 refrigerators
    b. 12 televisions and 16 refrigerators
    c. 8 televisions and 16 refrigerators
    d. 24 refrigerators

    ANS: B PTS: 1

77. According to Figure 2.2, exports for Canada total:
    a. 16 refrigerators
    b. 8 refrigerators
    c. 12 refrigerators
    d. 16 refrigerators

    ANS: B PTS: 1

78. According to Figure 2.2, imports for Canada total:
    a. 6 televisions
    b. 8 televisions
    c. 12 televisions
    d. 16 televisions

    ANS: C PTS: 1

79. Concerning possible determinants of international trade, which are sources of comparative advantage? Differences in:
    a. Methods of production
    b. Tastes and preferences
    c. Technological know-how
    d. All of the above

    ANS: D PTS: 1

80. Ricardo's model of comparative advantage assumed all of the following except:
    a. In each nation, labor is the only input
    b. Costs do not vary with the level of production
    c. Perfect competition prevails in all markets
    d. Transportation costs rise as distance increases between countries

    ANS: D PTS: 1

81. Ricardo's model of comparative advantage assumed all of the following except:
    a. Trade is balanced, thus ruling out flows of money between nations
    b. Firms make production decisions in an attempt to maximize profits
    c. Free trade occurs between nations
    d. Labor is immobile within a country, but is incapable of moving between countries

ANS: D PTS: 1

82. The dynamic gains from trade include all of the following except:
    a. Economies of large-scale production resulting in decreasing unit cost
    b. Increased saving and investment resulting in economic growth
    c. Increased competition resulting in lower prices and wider range of output
    d. Increasing comparative advantage leading to specialization

ANS: D PTS: 1

83. All of the following may be exit barriers except
    a. Employee health benefit costs
    b. Treatment, storage and disposal costs
    c. Penalties for terminating contracts with raw material suppliers
    d. Increasing opportunity cost of production

ANS: D PTS: 1

84. Incomplete specialization may be caused by
    a. Increasing opportunity cost
    b. Unrestricted trade
    c. Constant opportunity cost
    d. Decreasing opportunity cost

ANS: A PTS: 1

85. Improvements in productivity may lead to decreasing comparative costs if
    a. The assumption of fixed technologies under constant costs is relaxed
    b. Technologies available to each nation is allowed to differ
    c. Resource endowments are allowed to vary
    d. All of the above

ANS: D PTS: 1

86. Adam Smith
    a. Was a leading advocate of free trade
    b. Developed the concept of absolute advantage
    c. Maintained that labor costs represent the major determinant of production cost
    d. All of the above

ANS: D PTS: 1

87. Modern trade theory contends that the pattern of world trade is governed by
    a. Differences in supply conditions and demand conditions
    b. Supply conditions only
    c. Demand conditions only
    d. None of the above

ANS: A PTS: 1

88. When nations are of similar size, and have similar taste patterns, the gains from trade
    a. Are shared equally between them
    b. Are impossible to determine

c. Are too small, so that trading is not beneficial
d. Are determined by the nation that has comparative advantage in the more essential product

ANS: A PTS: 1

89. The commodity terms of trade measures
a. The rate at which exports exchange for imports
b. The influence trade has on productivity levels
c. The effect on income of the trading nation
d. The improvement in a nation's welfare

ANS: A PTS: 1

TRUE/FALSE

1. According to the mercantilists, a nation's welfare would improve if it maintained a surplus of exports over imports.

ANS: T PTS: 1

2. The mercantilists maintained that a free-trade policy best enhances a nation's welfare.

ANS: F PTS: 1

3. The mercantilists contended that because one nation's gains from trade come the expense of its trading partners, not all nations could simultaneously realize gains from trade.

ANS: T PTS: 1

4. According to the price-specie-flow-doctrine, a trade-surplus nation would experience gold outflows, a decrease in its money supply, and a fall in its price level.

ANS: F PTS: 1

5. The trade theories of Adam Smith and David Ricardo viewed the determination of competitiveness from the demand side of the market.

ANS: F PTS: 1

6. According to the principle of absolute advantage, international trade is beneficial to the world if one nation has an absolute cost advantage in the production of one good while the other nation has an absolute cost advantage in the other good.

ANS: T PTS: 1

7. The principle of absolute advantage asserts that mutually beneficial trade can occur even if one nation is absolutely more efficient in the production of all goods.

ANS: F PTS: 1

8. The basis for trade is explained by the principle of absolute advantage according to David Ricardo and the principle of comparative advantage according to Adam Smith.

ANS: F PTS: 1

9. The principle of comparative advantage contends that a nation should specialize in and export the good in which its absolute advantage is smallest or its absolute disadvantage is greatest.

ANS: F PTS: 1

10. The Ricardian theory of comparative advantage assumes only two nations and two products, labor can move freely within a nation, and perfect competition exists in all markets.

ANS: T PTS: 1

11. Assume that the United States is more efficient than the United Kingdom in the production of all goods. Mutually beneficial trade is possible according to the principle of absolute advantage, but is impossible according to the principle of comparative advantage.

ANS: F PTS: 1

12. It is possible for a nation not to have an absolute advantage in anything; but it is not possible for one nation to have a comparative advantage in everything and the other nation to have a comparative advantage in nothing.

ANS: F PTS: 1

13. Ricardo's theory of comparative advantage was of limited relevance to the real world since it assumed that labor was only one of several factors of production.

ANS: F PTS: 1

14. Compared to Ricardian trade theory, modern trade theory provides a more general view of comparative advantage since it is based on all factors of production rather than just labor.

ANS: T PTS: 1

15. Constant opportunity costs suggest that the relative cost of producing one product in terms of the other will remain the same no matter where a nation chooses to locate on its production-possibilities schedule.

ANS: T PTS: 1

16. There are two explanations of constant opportunity costs: (1) factors of production are imperfect substitutes for each other; (2) all units of a given factor have different qualities.

ANS: F PTS: 1

17. With increasing opportunity costs, a nation totally specializes in the production of the commodity of its comparative advantage; with constant opportunity costs, a nation partially specializes in the production of the commodity of its comparative advantage.

ANS: F PTS: 1

18. A nation's trade triangle denotes its exports, imports, and terms of trade.

ANS: T PTS: 1

19. International trade leads to increased welfare if a nation can achieve a post-trade consumption point lying inside of its production-possibilities schedule.

ANS: F PTS: 1

20. If the U.S. post-trade consumption point lies along its production possibilities schedule, the United States achieves a higher level of welfare with trade than without trade.

ANS: F PTS: 1

21. If productivity in the German computer industry grows faster than it does in the Japanese computer industry, the opportunity cost of each computer produced in Japan increases relative to the opportunity cost of a computer produced in Germany.

ANS: T PTS: 1

22. If Japan loses competitiveness in computers, Japanese computer workers lose jobs to foreign computer workers and the wages of Japanese computer workers tend to fall relative to the wages of foreign computer workers.

ANS: T PTS: 1

23. With constant opportunity costs, a nation will achieve the greatest possible gains from trade if it partially specializes in the production of the commodity of its comparative disadvantage.

ANS: F PTS: 1

24. By reducing the overall volume of trade, import restrictions tend to reduce a nation's gains from trade.

ANS: T PTS: 1

25. With increasing opportunity costs, comparative advantage depends on a nation's supply conditions and demand conditions; with constant opportunity costs, comparative advantage depends only on demand conditions.

ANS: F PTS: 1

26. According to the principle of comparative advantage, an open trading system results in resources being channeled from uses of low productivity to those of high productivity.

ANS: T PTS: 1

27. The existence of exit barriers tends to delay the closing of inefficient firms that face international competitive disadvantages.

ANS: T PTS: 1

28. MacDougall's empirical study of comparative advantage was based on the notion that a product's labor cost is underlaid by labor productivity and the wage rate.

ANS: T PTS: 1

29. The MacDougall study of comparative advantage hypothesized that in those industries in which U.S. labor productivity was relatively high, U.S. exports to the world should be lower than U.K. exports to the world, after adjusting for wage differentials.

ANS: F PTS: 1

30. The basic idea of mercantilism was that wealth consisted of the goods and services produced by a nation.

ANS: F PTS: 1

31. According to Adam Smith, international trade was a "win-win" situation since all nations could enjoy gains from trade.

ANS: T PTS: 1

32. The price-specie-flow mechanism illustrated why one nation's gains from trade were accompanied by another country's losses.

ANS: F PTS: 1

33. Complete specialization usually occurs under the assumption of increasing opportunity costs.

ANS: F PTS: 1

34. Adam Smith contended that gold, silver, and other precious metals constituted the wealth of a nation.

ANS: F PTS: 1

35. The price-specie-flow mechanism illustrated why nations could not maintain trade surpluses or trade deficits over the long run.

ANS: T PTS: 1

36. The marginal rate of transformation equals the absolute slope of a country's production possibilities schedule.

ANS: T PTS: 1

37. Assume that Germany has higher labor productivity and higher wage levels than France. Germany can produce a commodity more cheaply than France if its productivity differential more than offsets its wage differential.

ANS: T PTS: 1

38. Ricardo's theory of comparative advantage does <u>not</u> take into account demand conditions when determining relative commodity prices.

ANS: T PTS: 1

39. If Canada has a higher wage level and higher labor productivity than Mexico, Canada will necessarily produce a good at a higher labor cost than Mexico.

ANS: F PTS: 1

40. If Argentina has a comparative advantage over Brazil in beef relative to coffee, Argentina will specialize in beef production.

ANS: T PTS: 1

41. Modern trade theory recognizes that the pattern of world trade is governed by both demand conditions and supply conditions.

ANS: T PTS: 1

42. A nation achieves autarky equilibrium at the point where its community indifference curve is tangent to its production possibilities schedule.

ANS: T PTS: 1

43. In autarky equilibrium, a nation realizes the lowest possible level of satisfaction given the constraint of its production possibilities schedule.

ANS: F PTS: 1

44. A nation benefits from international trade if it can achieve a higher indifference curve than it can in autarky.

ANS: T PTS: 1

45. A nation realizes maximum gains from trade at the point where the international terms-of-trade line is tangent to its community indifference curve.

ANS: T PTS: 1

46. The Ricardian theory of comparative advantage could fully explain the distribution of the gains from trade among trading partners.

ANS: F PTS: 1

47. Because the Ricardian theory of comparative advantage was based only on a nation's demand conditions, it could not fully explain the distribution of the gains from trade among trading partners.

ANS: F PTS: 1

48. Because the Ricardian theory of comparative advantage was based only on a nation's supply conditions, it could only determine the outer limits within which the equilibrium terms of trade would lie.

ANS: T PTS: 1

49. The domestic cost ratios of nations set the outer limits to the equilibrium terms of trade.

ANS: T PTS: 1

50. Mutually beneficial trade for two countries occurs if the equilibrium terms of trade lies between the two countries' domestic cost ratios.

ANS: T PTS: 1

51. Assume that the United States and Canada engage in trade. If the international terms of trade coincides with the U.S. cost ratio, the United States realizes all of the gains from trade with Canada.

ANS: F PTS: 1

52. Assume that the United States and Canada engage in trade. If the international terms of trade coincides with the Canadian cost ratio, the United States realizes all of the gains from trade with Canada.

ANS: T PTS: 1

53. If the international terms of trade lies beneath (inside) the Mexican cost ratio, Mexico is worse off with trade than without trade.

ANS: T PTS: 1

54. Although J. S. Mill recognized that the region of mutually beneficial trade is bounded by the cost ratios of two countries, it was not until David Ricardo developed the theory of reciprocal demand that the equilibrium terms of trade could be determined.

ANS: F PTS: 1

55. According to J. S. Mill, if we know the domestic demand expressed by both trading partners for both products, the equilibrium terms of trade can be defined.

ANS: T PTS: 1

56. The theory of reciprocal demand asserts that as the U.S. demand for Canadian wheat rises, the equilibrium terms of trade improve for the United States.

ANS: F PTS: 1

57. Assume that Canada has a comparative advantage in wheat and a comparative disadvantage in autos. As the Canadian demand for wheat increases, Canada's equilibrium terms of trade improves.

ANS: F PTS: 1

58. The theory of reciprocal demand best applies when two countries are of equal economic size, so that the demand conditions of each nation have a noticeable impact on market prices.

ANS: T PTS: 1

59. The theory of reciprocal demand best applies when one country has a "large" economy and the other country has a "small" economy.

ANS: F PTS: 1

60. If two nations of approximately the same size and with similar taste patterns participate in international trade, the gains from trade tend to be shared about equally between them.

ANS: T PTS: 1

61. The expression "importance of being unimportant" suggests that if one nation is much larger than the other, the larger nation realizes most of the gains from trade while the smaller nation realizes fewer gains from trade.

ANS: F PTS: 1

62. An improvement in a nation's terms of trade occurs if the prices of its exports rise relative to the prices of its imports over a given time period.

ANS: T PTS: 1

63. If a country's terms of trade worsen, it must exchange fewer exports for a given amount of imports.

ANS: F PTS: 1

64. If a country's terms of trade improve, it must exchange more exports for a given amount of imports.

ANS: F PTS: 1

65. The terms of trade represents the rate of exchange between a country's exports and imports.

ANS: T PTS: 1

66. Assume 1990 to be the base year. If by the end of 2004 a country's export price index rose from 100 to 130 while its import price index rose from 100 to 115, its terms of trade would equal 113.

ANS: T PTS: 1

67. Assume 1990 to be the base year. If by the end of 2004 a country's export price index rose from 100 to 140 while its import price index rose from 100 to 160, its terms of trade would equal 120.

ANS: F PTS: 1

68. Assume 1990 to be the base year. If by the end of 2004 a country's export price index rose from 100 to 125 while its import price index rose from 100 to 125, its terms of trade would equal 100.

ANS: T PTS: 1

69. The commodity terms of trade are found by dividing a country's import price index by its export price index.

ANS: F PTS: 1

70. For the commodity terms of trade to improve, a country's export price index must rise relative to its import price index over a given time period.

ANS: T PTS: 1

71. For the commodity terms of trade to improve, a country's import price index must rise relative to its export price index over a given time period.

ANS: F PTS: 1

SHORT ANSWER

1. Is it possible to add up the preferences of all consumers in an entire nation?

ANS:
No. It is impossible to make interpersonal comparisons of satisfaction, and thus it is not possible to add up preferences.

PTS: 1

2. Who gains more from trade, when nations are of unequal economic size?

ANS:
If one nation is significantly larger than the other, the larger nation attains fewer gains from trade, while the smaller nation captures most of the gains from trade.

PTS: 1

3. Is it possible for comparative advantage to change, thus changing the direction of trade?

ANS:
Lagging productivity growth may cause a country to lose its comparative advantage. In a two-product, two-country model, this would change the direction of trade.

PTS: 1

4. Do national security concerns lead to incomplete specialization?

ANS:
Yes. National security concerns may lead a country to produce some of the commodity in which it has comparative disadvantage, thus leading to incomplete specialization.

PTS: 1

ESSAY

1. Will it be impossible to keep low-skilled jobs in the U.S.?

   ANS:
   If tax credits or other incentives are made available to U.S. companies, it would be possible for those companies to invest in training or technology for low-skilled workers. That would improve the efficiency of the workers. Such improvements in productivity can more than outweigh the wage advantage that is enjoyed by low-skilled workers overseas. New Balance Athletic Shoe Co. Inc., headquartered in Boston, Massachusetts, has been successful in retaining low-skilled production in the United States by increasing worker productivity.

   PTS: 1

2. Is it possible to estimate the gains from trade?

   ANS:
   When a nation trades, it enjoys a larger income, owing to a wider range of goods available to consumers. Trade also has a positive influence on productivity levels. However, it is extremely difficult to measure these gains, since it requires knowledge of what a nation's imports would cost if it produced them itself, instead of purchasing them from a less expensive source abroad.

   PTS: 1