

Midterm

International Economics
Monterey Institute of International Studies
Fall Semester 2002
Dr. Robert M. McNab

Instructions: You may use any material you believe necessary to answer each question, to include lecture notes, the recommended readings, or other materials. You may not collaborate in any way with another student in this class. The instructor reserves the right to give any student an oral exam in lieu of this written exam if collaboration is suspected. Contact the instructor immediately with any questions about the content, structure, or process of this examination.

Time: The deadline for this exam is Monday, November 4, 2002 at 4 pm. You may email your answers before the deadline or present your completed exam in person. The instructor will not accept exams that are turned in late.

Structure: Read each question carefully. In some cases, a question may be dependent upon your answer to a previous question. Answer each question to the best of your ability. Each answer will be graded completely, that is, if you include supplemental information in your answer that is not correct, the supplemental information will also be graded. Complete, concise answers have historically received higher grades than complete, rambling answers. Finally, the student should completely edit their exam to ensure that no significant style, grammar, or content errors remain before submitting the exam for grading.

1. Discussing theory (15 Points)
 - a. Discuss, in your own words, the concept of opportunity costs. Provide a numerical example of opportunity costs in production in an increasing cost environment. How would you explain opportunity costs to a non-economist policymaker?
 - b. Discuss, in your own words, the difference between constant opportunity costs in production and increasing opportunity costs in production. What are the implications for trade theory if one assumes constant opportunity costs in production?
 - c. With to the factor-endowment model, are preferences in consumption important in determining the autarkic and trading equilibriums? How is consumption treated in the model? Why is this important if one relies upon the results of the model to develop trade policy recommendations?
2. Discussing marginal returns in production and marginal utility in consumption and implications for trade theory (15 points)

- a. Discuss, in your own words, how the Laws of Diminishing Marginal Returns and Utility are related to indifference curves and transformation schedules (production possibilities frontiers), respectively, and how these observations can result in a linkage between indifference curves and the law of demand and transformation schedules and the law of supply.
 - b. Using (a) as the foundation for your discussion, discuss and provide examples of how you would explain these concepts to a non-economist policymaker.
 - i. **Bonus Question (5 points maximum):** Discuss the linkages between factor endowments, the relative price of each factor endowment and how it relates to the marginal productivity of each factor, and the specialization of a country in a specific good or goods.
3. Trade Theory and Linkages to Policy (20 Points)
- a. Explain in your own words how the devaluation of the Argentinean peso resulted in an increase in exports and a decrease of imports. Provide statistical information to support your argument on whether the devaluation of the peso was beneficial to the Argentinean trade sector.
 - b. Given the decline in economic output in Argentina over the past 4 years and the collapse of the industrial base, discuss how an increase in exports may, at this juncture, may not be beneficial to long-run economic development in Argentina. Make sure to think about the terms-of-trade of manufactured/service products relative to primary commodities when developing your response. Use trade theory to provide a rationale for your argument, that is, draw upon factor endowment theory and other discussions in class to support your argument.
 - c. Does trade theory suggest that there are instances when trade may actually harm economic development? Provide a specific argument where external trade may be harmful to economic growth and social welfare. Are there specific counter-arguments that suggest that, on the whole, trade is beneficial to economic growth?
4. Policy (50 Points – 3 Pages Maximum, Single Space)
- Refer to the instructions to the first policy memorandum in answering this question. Contact the instructor if there are any questions about the form, structure, or content of the policy memorandum. Answer the specific policy question detailed below.

As a recent graduate of MIIS, you are hired by the International Monetary Fund (IMF) to provide assistance to missions to Latin and South America. A specific concern of the ongoing missions in South American is that: (i) Argentina will fail to service its debt obligations to multi-lateral organizations (IMF, World Bank, IADB); or (ii) the new President-elect of Brazil will engage in a wave of populist-oriented expenditures, spurring increased inflation, a further devaluation of the Real, and an financial crisis in Brazil that may threaten the prospects for recovery in Argentina. Either scenario could adversely impact of the liquidity of these multi-lateral organizations and their ability to respond to other crises. In the long-term, these scenarios would require an additional infusion of capital from the member countries.

The Argentinean government is currently negotiating with the IMF for a short-term package that would allow the Argentinean government to meet its current multi-lateral debt obligations through 2003. While the overall size of the loan package is yet to be determined, the emerging consensus is that the loan package will be between 10 and 15 billion United States Dollars. The Argentinean government is also scheduled to open negotiations with private creditors in November, to whom it owes the bulk of its foreign debt.

With an awareness that events in Argentina are significantly influenced by emerging developments in Brazil and the potential need for the IMF and other multi-lateral lenders to aggressively combat the potential financial crisis in Brazil, two specific policy issues have emerged from the negotiations with the Argentinean government that require the attention of IMF staff.

1. Should the IMF should impose strict conditions on the loan package. As you are aware, if such a loan is made available, the Argentinean government will not need to service its multi-lateral debt until 2004. This could result in a significant increase in public funds that are currently committed to debt service. Current estimates place this amount between 14 and 18 percent of the central government budget. Are there specific benefits and dangers to this course of action?
2. Second, if the IMF provides such “rescue” package, there is concern that this effort could undermine the current efforts to develop the Sovereign Debt Restructuring Mechanism (SDRM). Should the IMF forgo the provision of the rescue package and immediately proceed to the implementation of the draft SDRM? What are the specific benefits and costs of this course of action from your view?

You have been tasked to develop a short policy memorandum addressing **one** of these two specific policy issues noted above, that is, you should choose to write on either policy issue (1) or (2).