Professor Robert Staiger

Economics 39F
Problem Set 2

1. True/False Explain: According to the Basic Trade Model, a country in which the autarky production level of a good is relatively high as compared to the rest of the world will export that good if trade is allowed.

2. True/False Explain: According to the Basic Trade Model, if a country could only trade with one trading partner and had several to choose from, it would choose the partner that induced the greatest reallocation of its productive activities.

3. True/False Explain: According to the Basic Trade Model, bigger countries stand to gain the most from (free) trade, while smaller countries stand to gain the least.

4. True/False Explain: According to the Basic Trade Model, if we were to think of the WTO as a big free-trade club, where member-countries trade freely with each other and do not trade at all with non-members, then a country like India (already a WTO member at the time that China joined the WTO in 2001) should have opposed the WTO membership application of China.

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Economics 166
Problem Set 2: Sketch of Answers

1. True/False Explain: According to the Basic Trade Model, a country in which the autarky production level of a good is relatively high as compared to the rest of the world will export that good if trade is allowed.

> False: This can be established by, for example, considering two countries that have identical technologies and endowments (and therefore identical PPFs) but different preferences. The country with the relatively strong preference for good x will produce this good at a relatively high level in autarky, and yet it will import the good if allowed to trade with the other country.

2. True/False Explain: According to the Basic Trade Model, if a country could only trade with one trading partner and had several to choose from, it would choose the partner that induced the greatest reallocation of its productive activities.

> False: This would only be true if each of the country's potential trading partners would import the same good from it. In that case, (i) the greater the reallocation of a country's productive activities from autarky to trade (for its given PPF), the greater the relative price change from autarky to trade, and (ii) the greater the relative price change from autarky to trade, the bigger the gains from trade for the country. But if this country would export different goods to different potential trading partners (i.e., export x to and import y from some potential trading partners, and export y to and import x from other potential trading partners), then (i) above need not hold.

3. True/False Explain: According to the Basic Trade Model, bigger countries stand to gain the most from (free) trade, while smaller countries stand to gain the least.

> False: An extreme case provides a counter example. Consider a country that is so small relative to its trading partner that it trades with its trading partner at the partner's autarky prices. Then all the gains from trade go to the small country. In fact, the opposite of this statement is more nearly true: according to the Basic Trade Model, relatively small countries tend to have more to gain from trade than relatively big countries.

4. True/False Explain: According to the Basic Trade Model, if we were to think of the WTO as a big free-trade club, where member-countries trade freely with each other and do not trade at all with non-members, then a country like India (already a WTO member at the time that China joined

the WTO in 2001) should have opposed the WTO membership application of China.

> True: If we call the pre-2001 WTO membership India and the West, and we think of India and China as, at a broad level, having more similar tastes, endowments and technologies relative to each other than to the West, then China's entry into the WTO in 2001 should have shifted out world supply of the good that India traditionally exported to the West by more than it shifted out world demand for that good (because like India, facing current free trade prices China would also export this good to the West), and this implies a (welfare-reducing) terms-of-trade decline for India upon China's entry into the WTO.