Field Examination in International Economics

Department of Economics, UC Berkeley, August 2007

Instructions: ***Answer both questions in Part A, and any two of the four questions in Parts B and C. You have three hours to complete the exam***

Part A

1. **Discuss the differences in the effects of protection of finished goods industries and of industries producing inputs, both from the point of view of static and dynamic implications.**

2 **(a) Suppose there are two goods, one agricultural (with constant returns to scale in production) and the other a manufacture (with increasing returns to scale). If between two otherwise identical countries, one has a demand function more biased in favor of manufacture, can there be any trade, and if so who will specialize in what? How will the results change if both goods were produced with constant returns to scale?**

(b) Under increasing returns to scale can there be trade between two countries even if they are identical in size, endowments, demand and production functions?

Part B

3. Standard International Business Cycle models assume efficient risk sharing, typically achieved by trading a complete set of Arrow-Debreu securities. Present and discuss critically the main elements of the following two models:

a. In the first model, agents have identical CRRA preferences, there are no transport costs and efficient risk sharing can be achieved with constant holdings of a riskless bond and of claims to future domestic and foreign output. Assuming that labor income is a constant fraction of domestic output, discuss what this implies for the optimal international portfolio allocation.

b. In the second model, preferences are such that efficient risk sharing can be achieved regardless of the international portfolio allocation. Be sure to explain how risk sharing is achieved in this model.
Discuss the implications of both models for the theoretical benefits of international risk sharing and contrast with the empirical evidence.

4. (a) Price levels are often higher in rich countries than in poor countries. Furthermore, it is often argued that countries with high productivity growth in the tradable sector (relative to the nontradable sector) experience an appreciation of their real exchange rate. Present the detailed elements of a theory that accounts for these two facts. How would you test the theory?

(b) A recent model argues that the world income distribution remains stable because rapidly growing countries experience a deterioration of their terms of trade. If that theory is correct, what would you infer for the cross-country correlation between terms of trade and real exchange rates? Can your answer to part (a) provide an alternative explanation for the stability of the world income distribution?

Part C

5. One of the most notable developments on the international economic scene in recent years is the large increase in the holdings of international reserves by the central banks of industrializing countries such as China, Korea, Russia, and Brazil. Can you advance some explanations of why the reserves of these central banks have increased to such a degree? Be sure to ask yourself whether the same goals could have been accomplished by other means, and under what conditions.

6. The United States is now running a current account deficit of about 6% of its GDP. Would the real exchange rate of the U.S. dollar have to change significantly were the current account gap to close suddenly? Discuss why or why not, including a discussion of how some different ways of closing the current account gap might affect the sign and magnitude of the necessary short-term real exchange rate adjustment. What factors would influence the long-term effect on the dollar's real exchange rate?