GEB 3373 Homework 5

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Chapter 6

> All uncited quotes are from the textbook

> 1. What is international trade? Why does it occur?

- **International Trade** is trade, "the voluntary exchange of goods, services, assets, or money between one person or organization and another," which happens between two countries.

> 2. How do the theories of absolute advantage and comparative advantage differ?

- **Absolute advantage** is a theory developed by Scottish economist Adam Smith which says that countries should export goods and services it has in excess and import goods and services of which it has a deficit. **Comparative advantage** is a theory from British economist David Ricardo that says that the same as Smith's theory, but instead of absolute production being the point of measure, the opportunity cost of the good or service is also considered.

> 3. Why are Leontief's findings called a paradox?

- Leontief's findings are called a paradox because his findings were the reverse of what was expected with the Heckscher-Ohlin theory. instead of imports being less capital intensive, exports were less capital intensive.
- **Leontief's Paradox** : Empirical finding that U.S. exports are more labor intensive than U.S. imports, which is contrary to the predictions of the theory of relative factor endowments."

> 4. How useful are country-based theories in explaining international trade?

- Country-based theories are useful when explaining international trade of commodoties such as oil or sugar while it is much less useful when analysing differentiated goods such as cars or cellphones.

> 5. How do interindustry and intraindustry trade differ?

- **Interindustry trade** is trade between one industry in one country with another industry in another country. This kind of trade *can* be predicted by country-based theories.
- **Intraindustry trade** is trade between the same industry in different countries. This kind of trade *cannot* be predicted by country-based theories.

> 6. Explain the impact of the product life cycle on international trade and international investment.

- "According to the international product life cycle theory, domestic production begins in stage 1, peaks in stage 2, and slumps in stage 3." Stage 1 is the new product stage. Stage 2 is the maturing product stage. Stage 3 is the standardized product stage. Exports follow a similar curve to the domestic production where it increases in Stage 1, peaks in Stage 2, and declines in Stage 3. This is because as production increases in Stage 1, foreign competitors take notice. In Stage 2 your competitors begin to produce their own version, then in Stage 3, your exports decline as your foreign competitors enter their own Stage 2.

> 7. What are the primary sources of the competitive advantages firms use to compete in international markets?

- Intellectual property rights such as trademarks
- Research and development (could also fall under intellectual property)
- Economies of scale
- Using their experience to their advantage

> 8. What are the four elements of Porter’s theory of national competitive advantage?

- Factor Conditions
- Demand Conditions
- Related and Supporting Industries
- Firm strategy, structure, and rivalry

> 9. How do foreign portfolio investments and FDI differ?

- **Foreign Portfolio Investments** are "Investments made in a host country by foreign investors not for purposes of control."
- **Foreign Direct Investments** are "Investments made for the purpose of actively controlling property, assets, or companies located in a host country."

> 10. What are the three parts of Dunning’s eclectic theory?

1. Ownership advantage
2. Location advantage
3. Internalization advantage

> 11. How do political factors influence international trade and investment?

- Companies will do what they can to maximize profits and reduce regulations placed upon them. By placing portions of their business in select countries, they are able to take these advantages.

Chapter 7

> 1. What is the function of the international monetary system?

- "The **international monetary system** establishes the rules by which countries value and exchange their currencies."

> 2. Why is the gold standard a type of fixed exchange rate system?

- The gold standard is a type of fixed exchange rate system because all the countries determine the value of gold to their currency individually and then trade currency in terms of gold. Thus, the value of gold itself is fixed.

> 3. What was the initial goal of the World Bank?

- "Established in 1945, the World Bank’s initial goal was to help finance reconstruction of the war-torn European economies"

> 4. Why was the IFC established by the World Bank?

- The **International Finance Corporation** was created to act as an investment banker to promote the "development of the private sector in developing countries."

> 5. Why are quotas important to IMF members?

1. "A country’s quota determines its voting power within the IMF."
2. "A country's quota serves as part of its official reserves"
3. "The quota determines the country's borrowing power from the IMF"

> 6. Why did the Bretton Woods system collapse in 1971?

- The Bretton Woods system collapsed because of an incident closely resembling a bank run where "The Bank of England could not counter the flood of pounds dumped on the market by speculators and was forced to devalue the pound by 14.3 percent (from $2.80 to $2.40 per pound)"

> 7. Describe the differences between a fixed exchange rate system and a flexible exchange rate system.

- In a fixed exchange rate system, monetary value is determined by how much another country is willing to pay for the same amount of gold. In a flexible exchange rate system, monetary value is determined by how much of another country's currency one country is willing to accept in exchange for its own (supply and demand).

> 8. List the four major accounts of the BOP accounting system and their components.

1. **Current Account**
    1. Imports and exports of goods
    2. Imports and exports of services
    3. Investment income
    4. Gifts
2. **Capital Account**
    1. Short term potfolio
    2. Long term portfolio
    3. Foreign Direct Investment
3. **Official Reserves Account**
    1. Gold
    2. Convertible currencies
    3. SDR
    4. Reserve positions at the IMF
4. **Errors and Omissions**
    1. Current Account + Capital Account + Official Reserves Account = 0
    2. Current Account + Capital Account + Official Reserves Account + Errors and Omissions = 0
    3. Flight Capital

> 9. What factors cause measurement errors in the BOP accounts?

- "Experts suspect that a large portion of the errors and omissions account balance is the result of the underreporting of capital account transactions."
- "Sometimes, errors and omissions are due to deliberate actions by individuals who are engaged in illegal activities such as drug smuggling, money laundering, or evasion of currency and investment controls

imposed by their home governments."

- "Some errors may crop up in the current account as well. Statistics for merchandise imports are generally thought to be reasonably accurate because most countries' customs services scrutinize imports to ensure that all appropriate taxes are collected."

> 10. Identify the different types of balance of payments surpluses and deficits.

- There are no surpluses or deficits to the BOP because the balances always equal zero. If someone says there is a surplus or deficity, they are mistaken or referring to a subsection of the BOP.