Question 2

7 points (3 + 3 + 1)

(a) 3 points:
- One point is earned for stating yes for Mexican consumers.
- One point is earned for stating no for Mexican manufacturers.
- One point is earned for the explanation that reducing tariffs will cause the domestic price of automobiles to fall in Mexico, lowering the production of cars in Mexico.

(b) 3 points:
- One point is earned for indicating that the current account will move toward a deficit.
- One point is earned for the explanation that the reduction in tariff increases imports relative to exports.
- One point is earned for stating that the capital account will move toward a surplus.

(c) 1 point:
- One point is earned for concluding that aggregate demand will decrease.

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Write in the box the number of the question you are answering on this page as it is designated in the exam.

2

2A

N2

a) i) Mexican consumers will benefit since the prices for imported automobiles will fall

ii) Mexican automobile manufacturers will suffer since their ~~prod~~ cars will become relatively more expensive. There will be higher competition on automobile market.

b) i) Since tariffs decrease, the price of an imported automobile falls. Consequently imports rise, ~~and~~ net exports fall. Current account will decrease.

ii) Capital account will rise

c) Since net exports is a component of aggregate demand, aggregate demand will fall.

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2

2B

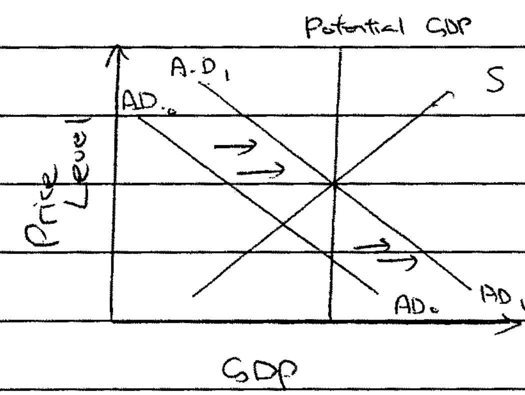
2(a) i Yes, consumers will be able to buy goods at the natural market clearing price and not the artificially high foreign exporting price due to government-imposed tariff.

ii No, there will be more competition from foreign automakers to compete with Mexican automobile manufactures in fighting for businesses.

(b) i Current account balance decreases since trade deficit arises as a result of Export − Import (where import is greater than export)

ii Capital account balance decreases since current account balance (which capital account is part of) decreases

(c) Aggregate demand will shift out to combat the gap created by negative net export. This can be accomplished by increasing government spending or permanent lowering of tax to induce spending (consumption)



The "recessionary gap" made by negative net export is filled by the outward push of Aggregate demand.

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2

2C

a) i) Mexican consumers will benefit from the decrease in the tariff rate. They would have ability to buy foreign cars for lover prices, they would have better choice and domestic cars would probably become cheaper because they would have to compete with a lot of foreign cars, sometimes with better quality.

ii) Mexican automobile manufacturers would not benefit from the decrease in the tariff rate, it would hurt them. High tariff rates protect domestic manufacturers, because their car are relatively cheaper then imported cars of the same class. Whe tariffs are lowered, imported cars become relatively same in price with domestic, while they (foreign cars) maybe have some (non-price) benefits for consumers that domestic cars dont have. Moreover, Mexico is not a main international car producer, so mexican automobile manufacturers would not be able to compete with large foreign brands if ~~becaus~~ their prices would be the same. Car production costs are maybe higher for small Mexican manufacturers then ~~for~~ large foreign ones.

b) i) Decreasing in tariffs would cause ~~exceed~~ increase in demand for foreign cars, this would create capital outflow.

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Question 2

Sample: 2A
Score: 7

The student earned all points in this question.

Sample: 2B
Score: 5

The student earned all 3 points in part (a) and 2 points in part (b). One point in part (b) was not earned because the capital account should move toward surplus if the current account is moving toward deficit. The point in part (c) was not earned because aggregate demand should be decreasing.

Sample: 2C
Score: 3

The student earned all 3 points in part (a). The student lost all points in part (b) for not referring to the current account and the capital account. The point in part (c) was not earned because the student does not give an answer.

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