

This review sheet is intended to cover everything that could be on the exam; however, it is possible that I will have accidentally left something off. You are still responsible for everything in the chapters covered except anything that I explicitly say you are not responsible for. Therefore, if I left something off of this sheet, it can still be on the exam. There will be no multiple-choice questions. Most of the questions will be like the ones in the homework assignments, and possibly a few definition questions, but I am more likely to ask questions that make you use the definitions rather than recite them. I will probably ask one of the questions from the book at the end of the chapters.

The review session will be at a time to be determined in class, probably Sunday 2/18.

Chapter 1: What is meant by *international trade*?

Chapter 2: What is meant by **absolute advantage** and **comparative advantage**? Be able to figure both out. Which determines trade patterns? When given information like the one in Question #2 on Homework #1, be able to find the comparative advantage, absolute advantage, draw the **PPF** and **CPF** diagrams for the two countries with **constant marginal costs**, and draw the **supply/demand** diagram for both goods. Be able to answer the question with the units of the numbers' being written as **hours per unit** and **units per hour**. Be able to prove the **Law of Comparative Advantage** and understand why it holds. Understand how both countries gain from trade when compared to **autarky**. Why might neither country have a comparative advantage in either good? All of this assumes we trade goods, how does it work with **currency**? Note that the graphs on Pages 45 & 47 implies **Ricardo's Model** holds in the real world.

Chapter 3: Explain why **increasing marginal costs** exists and causes the PPF to curve down. Why is the slope of the PPF equal to $-MRT_{xy}$? Know the properties of **isobars**. (They cannot cross. Each curve has its own value. Every point is on a curve.) Know the additional properties of **indifference curves**. (They must slope down. As you move up/right, their value increases.) Know why the absolute value of the slope of an indifference curve is the $-MRS_{xy}$. Be able to find the **autarky point**. For a **small country**, be able to find the utility maximizing **production point** and **consumption point**. Hint: The CPF must be tangent to the PPF and to the indifference curve. Be able to do the same using two graphs, one for each of the two **large countries**. Hint: To make sure the exports of one country are the same as the imports for the other country, first find the two countries consumption and production points. Then draw the CPF and finally the PPF and indifference curves. It will be easier to get the diagram correct. Also be able to use one diagram to show how two countries with **identical tastes** may gain from trade and two countries with **identical production capabilities** may gain from trade. **Note all of the slopes are upside-down from what you would expect.** The absolute value of the slope of the PPF (MRT_{xy}) is the opportunity costs of the good on the X-axis. The absolute value of the slope of the indifference curve (MRS_{xy}) is the rate you will be willing to give up the Y-axis good to get one unit of the X-axis good. The absolute value of the slope of the CPF is the relative price of the X-axis good (P_x/P_y).

Chapter 4: Know the difference between **partial equilibrium** and **general equilibrium**. Be able to use two individual countries' supply/demand diagrams for a single good to determine the **supply and demand for trade of a good**. Be able to derive both countries' **offer curves** from their respective PPF/indifference curve diagrams. Note that offer curves are general equilibrium. Understand why they take their respective shapes. How do we use them to find the relative prices of the goods with free trade? Understand how we derive the **general equilibrium supply and demand diagram** for a product. *Note that you can tell it apart from the partial equilibrium supply and demand by looking at the Y-axis. The*

*general equilibrium diagram has the relative price of the good (P_x/P_y) while the partial equilibrium graph has the price of the good (P_x). What is meant by **terms of trade, TOT**? In Appendix A4.3, understand why the **trade indifference curves** take their shape and how they can be used to derive the offer curve. In Appendix A4.6, be able to tell if an equilibrium is **stable** or **unstable**. Hint: Take a price line near the equilibrium, but not at it. Determine if there is excess supply or excess demand for the good on the X-axis. That will tell you if the price will rise or drop.*

Non-graded Homework Assignment #2A to be reviewed with Assignment #2.

- 1) (20 points) Draw the offer curve diagram for the USA and Japan. Illustrate the USA having a comparative advantage in food while Japan has a comparative advantage in cars. Explain how you know which curve is the one for the USA. Prove the equilibrium is stable.
- 2) (30 points) Draw the offer curve diagram for the UK and the EU. Draw it such that the EU has a comparative advantage in hats and the UK has the comparative advantage in computers. Draw the trade indifference curves for the UK. Explain how you know you drew their curves correctly. If the UK could choose a point on the EU's offer curve, where would it be? Explain your logic.
- 3) (5 points) The second time we derived the offer curves, we found the tangency of the trade indifference curves and the TOT line. Why would that method work?
- 4) (45 points) Draw the PPF for the USA for telephones and sculptures. Assume the USA has a comparative advantage in sculptures. Use your diagram to find two points on our offer curve. Plot those to points and the autarky point. Explain what you did.