

1. Consider two economies, Argentina and Brazil, with no other trading partners. Argentina exports agricultural goods (Q_A) and imports industrial goods (Q_I), and trade is balanced. Suddenly, political and macroeconomic turmoil in Argentina leads Argentinian investors to transfer a substantial amount of their savings to Brazil, where it can be invested. Note that the following questions do not require graphs, only directional changes.

- a) How would this transfer affect the current account balance in Argentina and Brazil?
- b) How would this transfer affect the value of the Brazilian Real (pronounced Ree-Al), in Argentinian Pesos (FYI, the current rate is 1 Real = 1.37 Pesos).
- c) How would this transfer affect overall spending (this is really consumption plus investment, but we are ignoring the intertemporal effects) and current welfare in both Argentina and Brazil?
- d) How would this transfer affect the volume of exports and the volume of imports in Brazil?
- e) Assuming that the income elasticities for both agricultural and industrial goods were equal to one, how would this transfer affect Brazil's terms of trade with Argentina?
- f) Assume instead that the demand income elasticity for agricultural goods is less than one (i.e., a 1% increase in income causes a 0.5% increase in demand for agricultural products) spending), while the demand income elasticity for industrial products is greater than one. How would the transfer affect Brazil's terms of trade?

2. Putting Q_A on the horizontal axis, draw Brazil's PPF and show its free trade equilibrium. (This is easier to see if you exaggerate its comparative advantage in Q_I and also bias its indifference curves towards consumption of Q_A .) Assuming its terms of trade are unaffected, show how the above transfer affects its production, its overall spending, and its volume of exports and imports.

3. Draw Brazil's PPF and free trade equilibrium again, but this time ignore the transfer and assume that Brazil puts a tariff on its agricultural imports.

- a) Assuming Brazil's external terms of trade are unaffected by the tariff, show how the tariff changes the domestic relative price (P_A/P_I), and how this leads to inefficient production, inefficient consumption, and lower overall welfare.
- b) If Brazil's external terms of trade rise because of the tariff, since Brazil is buying less of the import good, could the tariff actually enhance Brazil's overall welfare? If so, show this.