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CHAPTER 2
EARLY TRADE THEORIES:
Mercantilism and the Transition to the Classical World of David Ricardo

A. Essay Questions

1. Explain how the price-specie-flow mechanism operates to maintain balanced trade between countries. What are the assumptions that are critical to the mechanism's successful operation?

   Answer: A trade surplus (or deficit) automatically produces internal repercussions that work to remove that surplus (or deficit). The movement of specie between countries serves as an automatic adjustment mechanism that always seeks to equalize the value of exports and imports. The key assumptions are that all currencies are pegged to gold and hence to each other, all currencies are freely convertible into gold, gold can be bought and sold at will, and governments do not offset the impact of the gold flows on the money supply. Also, it is crucial that prices and wages be flexible.

   Difficulty: 02 Medium
   Topic: Mercantilism
   AACSB: Reflective Thinking
   Blooms: Understand
   Learning Objective: 01-01

2. Why was a positive trade balance so important to Mercantilists? In Mercantilist thinking, why did a positive trade balance not result in domestic inflation and a loss of international competitiveness?

   Answer: The inflow of specie came from foreigners who paid for the excess purchases from the home country with gold and silver. For Mercantilists, a positive trade balance did not result in domestic inflation because of the belief that the economy was operating at less than full employment; therefore, the increase in the money supply stimulated the economy instead of creating inflation.

   Difficulty: 02 Medium
   Topic: Mercantilism
   AACSB: Reflective Thinking
   Blooms: Understand
   Learning Objective: 01-01

3. What were the critical foundations of Mercantilist thought? What trade policies resulted from this way of thinking?

   Answer: The acquisition of precious metals was seen as the means for increasing wealth and well-being. Mercantilists saw the enhancement of state power as being critical to the growth process. The Mercantilists employed a labor theory of value in their analysis and stressed

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the need to maintain an excess of exports over imports. Finally, one of the most important pillars of Mercantilist thought was the static view of world resources.

Difficulty: 02 Medium
Topic: Mercantilism
AACSB: Reflective Thinking
Blooms: Understand
Learning Objective: 01-01

4. Explain what is meant by a zero-sum game, and why it was central to Mercantilist thinking. Then, explain how Smith's idea of absolute advantage altered the nature of the "game."

Answer: A zero-sum game is a game such as poker where one person's winnings are matched by the losses of the other players. The Mercantilists held a static view of world resources, so that one country's economic gain was at the expense of another.

Difficulty: 02 Medium
Topic: Mercantilism
AACSB: Reflective Thinking
Blooms: Understand
Learning Objective: 01-01

5. (a) Why did the Mercantilists think that a situation where a country's exports exceed its imports is a "favorable" situation for the country? Briefly, what policies would a Mercantilist recommend in order to generate such a "favorable" situation?

Answer: A positive trade balance generated specie from foreigners who paid for their excess purchases from the home country with gold and silver. Governments attempted to control international trade with specific policies to maximize the likelihood of a positive trade balance and the resulting inflow of specie. Exports were subsidized and quotas and high tariffs were placed on imports of consumption goods. Tariffs on imports of raw materials that could be transformed by domestic labor into exportables were, however, low or nonexistent.

Difficulty: 02 Medium
Topic: Mercantilism
AACSB: Reflective Thinking
Blooms: Understand
Learning Objective: 01-01

(b) What was the "price-specie-flow doctrine" and how did it undermine Mercantilist thinking? Why would a situation where the demands for traded goods are "inelastic" with respect to price changes pose a problem for the "price-specie-flow doctrine" in its attack on Mercantilist thinking?

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Answer: The price-specie-flow doctrine asserted that a trade surplus (or deficit) automatically produces internal repercussions that work to remove that surplus (or deficit). The movement of specie between countries serves as an automatic adjustment mechanism that always seeks to equalize the value of exports and imports. Inelastic demands for traded goods would cast doubt on the adjustment process.

Difficulty: 03 Hard
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Analytic
Blooms: Apply
Learning Objective: 01-02

6. During the 2016 campaigns for nomination for president of the United States, the point was frequently made that the United States was losing from trade with any given country if the United States had a trade deficit with that country. Using material from this chapter, assess this position.

Answer: To argue that the United States was losing from trade with any given country if the United States had a trade deficit with that country is to display a gross misunderstanding of reality.
Difficulty: 03 Hard
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Analytic
Blooms: Evaluate
Learning Objective: 01-02

B. Multiple-Choice Questions

7. In Adam Smith's view, international trade

a. benefited both trading countries.
b. was based on absolute cost differences.
c. reflected the resource base of the countries in question.
d. all of the above.

Answer: d
Difficulty: 01 Easy
Topic: Mercantilism
AACSB: Reflective Thinking
Blooms: Remember
Learning Objective: 01-01

8. In the price-specie-flow doctrine, a deficit country will _____ gold, and this gold flow will ultimately lead to _____ in the deficit country's exports.

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a. lose; a decrease
b. lose; an increase
c. gain; a decrease
d. gain; an increase

Answer: b
Difficulty: 01 Easy
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Remember
Learning Objective: 01-02

9. Two important assumptions contained in David Hume's price specie-flow adjustment mechanism are that

a. countries are at full employment and the demands for traded goods are "inelastic."
b. countries are at full employment and the price level of a country moves in inverse proportion to movements in the country's money supply.
c. a country with a balance-of-payments deficit will experience a gold outflow and countries are at a level of employment that is below full employment.
d. the demands for traded goods are "elastic" and countries are at full employment.

Answer: d
Difficulty: 01 Easy
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Remember
Learning Objective: 01-02

10. In the Mercantilist view of international trade (in a two-country world),

a. both countries could gain from trade at the same time, but the distribution of the gains depended upon the terms of trade.
b. both countries could gain from trade at the same time, and the terms of trade were of no consequence for the distribution of the gains.
c. neither country could ever gain from trade.
d. one country's gain from trade was associated with a loss for the other country.

Answer: d
Difficulty: 01 Easy
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Remember

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Learning Objective: 01-02

11. Given the following Classical-type table showing the number of days of labor input required to obtain one unit of output of each of the two commodities in each of the two countries:

	bicycles	computers
United States	4 days	3 days
United Kingdom	5 days	6 days

The United States has an absolute advantage in the production of _____.

a. bicycles (only)
b. computers (only)
c. both bicycles and computers
d. neither bicycles nor computers

Answer: c
Difficulty: 01 Easy
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Remember
Learning Objective: 01-02

12. According to the labor theory of value,

a. the value of labor is determined by its value in production.
b. the value of a good is determined by the amount of labor with which each unit of capital in an industry works.
c. the price of a good A compared to the price of good B bears the same relationship as the relative amounts of labor used in producing each good.
d. the values of two minerals such as coal and gold with similar production costs may be very different.

Answer: c
Difficulty: 01 Easy
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Remember
Learning Objective: 01-02

13. If the demand for traded goods is price-inelastic, the price-specie-flow mechanism will result in

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a. gold movements between countries that remove trade deficits and surpluses.
b. gold movements between countries that worsen trade deficits and surpluses.
c. negligible movements of gold between countries and hence little or no adjustment of trade deficits and surpluses.
d. a removal of the basis for trade between countries.

Answer: b
Difficulty: 01 Easy
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Understand
Learning Objective: 01-02

14. Which of the following policies would *NOT* be consistent with the Mercantilist balance-of-trade doctrine?

a. payment of high wages to labor
b. import duties on final products
c. export subsidies
d. prohibition of imports of manufactured goods

Answer: a
Difficulty: 02 Medium
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Understand
Learning Objective: 01-02

15. During the price-specie-flow adjustment process to a trade imbalance, if demands for goods are *inelastic*, then, when the price level _____ in the country with the trade deficit, the value of that country's exports will _____ as the price-specie-flow process takes place.

a. falls; increase
b. falls; decrease
c. rises; increase
d. rises; decrease

Answer: b
Difficulty: 02 Medium
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Understand
Learning Objective: 01-02

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16. The price-specie-flow mechanism suggested that

a. a country could easily maintain a balance-of-payments surplus for a long period of time.
b. a deficit country would experience an increase in its money supply and its price level.
c. a surplus country would experience an increase in its money supply and its price level.
d. a country's internal price level has no relation to the country's foreign trade activities.

Answer: c
Difficulty: 01 Easy
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Remember
Learning Objective: 01-02

17. David Hume's price-specie-flow mechanism

a. reinforced the Mercantilist notion that a country could maintain a permanent "favorable" balance of trade where exports exceeded imports.
b. works more effectively if demands for traded goods are "price-elastic" rather than "price-inelastic."
c. assumed that the countries involved have substantial unemployment.
d. works equally effectively whether demands for traded goods are "price-elastic" or "price-inelastic."

Answer: b
Difficulty: 01 Easy
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Remember
Learning Objective: 01-02

18. The policy of minimum government interference in or regulation of economic activity, advocated by Adam Smith and the Classical economists, was known as

a. the law of comparative advantage.
b. laissez-faire.
c. the labor theory of value.
d. Mercantilism.

Answer: b
Difficulty: 01 Easy
Topic: The Challenge to Mercantilism by Early Classical Writers
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Learning Objective: 01-02

19. A Mercantilist policymaker would be in favor of which of the following policies or events pertaining to his/her country?

a. a decrease in the size of the population
b. a minimum wage bill to protect the standard of living of workers
c. a prohibition on the export of manufactured goods
d. an increase in the percentage of factors of production devoted to adding value to imported raw materials in order to later export the resulting manufactured goods.

Answer: d
Difficulty: 02 Medium
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Understand
Learning Objective: 01-02

20. In the context of David Hume's price-specie-flow mechanism that challenged the feasibility of the Mercantilist ideas regarding a trade surplus, which one of the following statements is **NOT** correct?

a. There is a decrease in the money supply in the deficit country.
b. There is an increase in the price level in the surplus country.
c. There is an increase in real income in the surplus country.
d. Price changes in the surplus country cause that country's exports to decrease.

Answer: c
Difficulty: 02 Medium
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Understand
Learning Objective: 01-02

21. In David Hume's price-specie-flow doctrine or adjustment mechanism, the assumption is made that changes in the money supply have an impact on _____. Further, the demand for traded goods is assumed to be _____ with respect to price.

a. prices rather than on output; elastic
b. prices rather than on output; inelastic
c. output rather than on prices; elastic
d. output rather than on prices; inelastic

Answer: a
Difficulty: 02 Medium

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Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Understand
Learning Objective: 01-02

22. The "paradox of Mercantilism" reflected that fact that

a. trade surpluses were fostered by protective tariffs.
b. rich countries were comprised of large numbers of poor people.
c. gold inflows led to higher prices and reduced exports.
d. gold could not be hoarded and provide money for the economy at the same time.

Answer: b
Difficulty: 01 Easy
Topic: Mercantilism
AACSB: Reflective Thinking
Blooms: Remember
Learning Objective: 01-01

23. With M_S = supply of money, V = velocity of money, P = price level, and Y = real output, which one of the following indicates the quantity theory of money expression?

a. $M_SY = PV$
b. $M_SP = VY$
c. $M_S = PY - V$
d. $M_SV = PY$

Answer: d
Difficulty: 01 Easy
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Remember
Learning Objective: 01-02

24. In the price-specie-flow mechanism, there is a gold _____ a country with a balance-of-trade surplus, and this gold flow ultimately leads to _____ in the surplus country's exports.

a. inflow into; an increase
b. inflow into; a decrease
c. outflow from; an increase
d. outflow from; a decrease

Answer: b
Difficulty: 01 Easy
Topic: The Challenge to Mercantilism by Early Classical Writers

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Blooms: Remember
Learning Objective: 01-02

25. In the price-specie-flow adjustment mechanism, a country with a balance-of-trade surplus experiences

a. a gold inflow and a decrease in the price level.
b. a gold outflow and an increase in the money supply.
c. an increase in the money supply and a decrease in exports.
d. a decrease in the money supply and a decrease in imports.

Answer: c
Difficulty: 01 Easy
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Reflective Thinking
Blooms: Remember
Learning Objective: 01-02

26. Suppose that country A's total exports are 10,000 units of good X at a price of $20 per unit, meaning that country A's export earnings or receipts are $200,000. Suppose also that the foreign price elasticity of demand for country A's exports of good X is (-) 0.6. If country A's prices for all goods, including its exports, now rise by 10% because of a gold inflow such as in the Mercantilist model, then, other things equal, country A's exports of good X will fall by _____ and country A's export earnings or receipts will become _____.

a. 600 units; less than $200,000
b. 600 units; greater than $200,000
c. 1,000 units; less than $200,000
d. 1,000 units; greater than $200,000

Answer: b
Difficulty: 03 Hard
Topic: The Challenge to Mercantilism by Early Classical Writers
AACSB: Analytic
Blooms: Apply
Learning Objective: 01-02

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