Part I. (30 points) You have just accepted a position as an intern at the Congressional Budget Office and your new boss is eager to get you working on things that she anticipates will come up soon after you arrive in Washington to start your job. She just read a story that the New York Times ran on October 5 with the headline “United States Trade Deficit Shrinks in August as Exports Rise.” As the article noted:

“...The trade deficit is closely watched and routinely cited by President Trump, who often points to the gap as evidence that global trade is not benefiting the United States in the way that it should. He has promised that his America-first trade policy will help to shrink the trade deficit, consistently citing bilateral deficits that form between two countries as a sign that the United States is losing when it comes to global trade. And he has typically blamed trade agreements and negotiators who failed to hammer out the best terms for American exporters.”

Your boss emails you the following question, which I have pasted in below (and which you should answer!):

As economists, we often explain to Congress that the US multilateral trade deficit reflects savings and investment decisions in the United States that have little to do with trade policy and trade agreements; and we claim that bilateral trade deficits are economically irrelevant and should not be the focus of policy, trade or otherwise. Can you check this second claim for me, by using a 3-country version of the Basic Trade Model?

More specifically, here is what I would like you to do. Suppose that initially the US is importing good y from Brazil and Italy and exporting good x to Brazil and Italy under conditions of free trade (Brazil and Italy do not trade with each other in the 2-good 3-country version of the Basic Trade Model). And suppose as well that US multilateral trade is balanced, and that initially this multilateral balance is achieved with bilaterally balanced trade between the US and Brazil and bilaterally balanced trade between the US and Italy. Finally, suppose that Italy consumes goods x and y in fixed and equal proportions (Leontief indifference curves with vertices along a line from the origin with slope 1) while Brazil consumes goods x and y in a fixed proportion of 2 y for every 1 x (Leontief indifference curves with vertices along a line from the origin with slope 2).

Using the above specifications for the Basic Trade Model, first depict the initial trading equilibrium for the three countries. Then consider the following change to the initial situation you have depicted: suppose that the US begins running a bilateral trade deficit with Italy and a bilateral trade surplus with Brazil of the same magnitude, so that the US multilateral trade balance -- which is the sum of its bilateral deficit with Italy and its bilateral surplus with Brazil -- is still zero (we don’t need to say how this happens, let’s just assume that it somehow happens). Is it true that this change would be economically irrelevant to the United States? Please advise.
**Part II.** Answer *either* question 1 or question 2 below.

1. (20 points) In the slides from the first day of class, we discussed James Meade and the Haberler Report that was written for the GATT. The portion of the Report quoted in the slides describes the impacts on other countries created when one country imposes an import tariff (described for illustrative purposes in the particular context of imports of an agricultural product), and says in part the following:

   “…In general, if one considers any particular agricultural product, a protective stimulus to its production in any one country by increasing supplies relatively to the demand for that product will tend to depress the world market for that product. This will damage the interests of other countries which are exporters of the product on the world market. But it will be to the national interest of countries which import the product from world markets.”

Using a 3-country version of the Basic Trade Model, with country A importing good y from countries B and C and exporting good x to countries B and C (countries B and C do not trade with each other in the 2-good 3-country version of the Basic Trade Model), confirm that, beginning from the free trade equilibrium of this model, if country B imposes an import tariff on its imports of x, this will “damage the interests” of the country that exports good x (country A) but it will “be to the national interest” of the other country that also imports good x (country C). [In answering this question, you may assume that the tariff revenue generated from B’s tariff is redistributed to B’s consumers].

2. (20 points) Suppose we observe two countries that are trading with the world at the same international prices, have the same levels of GNP measured at those prices, and have the same volume of imports of the same good at those prices. But suppose we have also been told that country 1 has a very inelastic demand for imports while country 2 has a very elastic demand for imports. Using the 2-good Basic Trade Model as your guide, explain which of these two countries is likely to be enjoying the largest gains from trade.