1. (25%) The Solow model predicts convergence of income in the long run. However, the world incomes become diverge more than convergence: the rich countries become richer while the poor countries poorer, as illustrated in Figure 1. However, there is a small group of countries (Taiwan, Singapore, South Korea, and Hong Kong) do converge with the OECD countries regarding per capita income.
   (a) Please, based on the augmented Solow model, provide three reasons to explain why these Eastern Asian countries can converge with the OECD countries while the South American countries cannot? (15%)
   (b) Please explain why the per capita GDP growth rates of OECD countries are about 2% annually? (5%)
   (c) Why doesn't capital flow from the rich countries to poor countries? (5%)

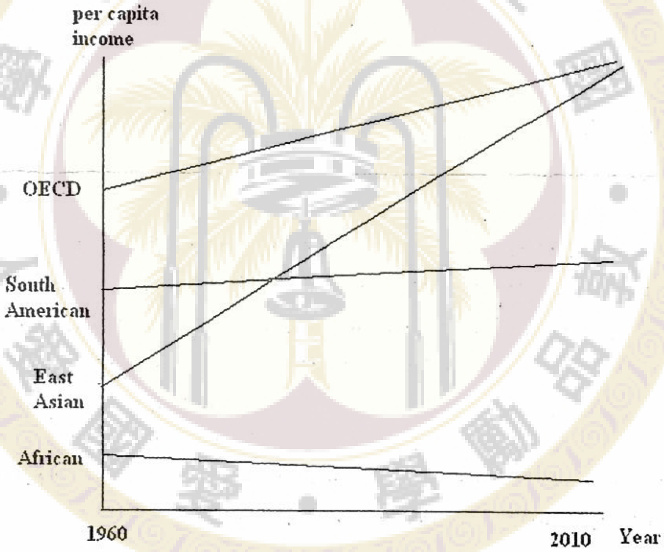

Figure 1

2. (10%) Neil C. Hughes: "With Chinese growth rates consistently above nine percent, many people accuse it of stealing U.S. jobs, of keeping the yuan undervalued by pegging it to the dollar, of exporting deflation by selling its products abroad at unfair prices, of violating the rights of its workers to keep labor costs low, and of failing to meet its commitments to the World Trade Organization (WTO). Most of these charges have little merit. But the misunderstandings behind them have opened the way to a trade war between the United States and China -- one that, if it escalates, could do considerable damage to both sides." (2005,

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Foreign Affairs). Please illustrate why if the U.S. government once launches a protectionist policy against Chinese exports could do considerable damage to both sides? What are these damages?

3. (15%) Please illustrate the IS-LM model, based on the **Keynesian Cross**, in short-run equilibrium in a closed economy (must first write down the IS and LM functions and then explain how you get the IS and LM curves) (10%). Then answer the question: if the Central Bank has the first priority at depressing the prices of real estate, what is the impact of the possible policies on interest rate? Please illustrate (5%).

4. (25%) Please explain each term briefly (5% each)
   1) Adverse Selection
   2) Coase Theorem
   3) Law of One Price
   4) Monopolistic Competition
   5) Giffen's Paradox

5. (25%) Suppose that the current market price (P) of VCRs is USD$300, that average consumer disposable income (I) is USD$30,000, and that the price (P') of DVD players (a substitute for VCRs) is USD$500. Under these conditions the annual U.S. demand (Q) for VCRs is 5 million per year. Statistical studies have shown that for this product $E_{Q,P} = -1.3$, $E_{Q,I} = 1.7$, and $E_{Q,P'} = 0.8$ where $E_{Q,P}$ is the price elasticity of demand, $E_{Q,I}$ is the income elasticity of demand, and $E_{Q,P'}$ is the cross-price elasticity of demand. Use this information to predict the annual number of VCRs sold under the following conditions:
   1) Increasing competition from Korea causes VCR prices to fall to USD$270 with I and P' unchanged.
   2) Income tax reductions raise average disposable income to USD$31,500 with P and P' unchanged.
   3) Technical improvement in DVD players cause their price to fall to USD$400 with P and I unchanged.
   4) All of the events described in parts 1) through 3) occur simultaneously.