Soochow University, Winter Session I, 2021
ECON202
Discussion Session I Solution

Question 1. Compare and contrast the classical and Keynesian schools of thought for the following economic issues.

(a) The flexibility of wages and prices.

Answer The flexibility of wages and prices is a principal point of disagreement between classical economists and Keynesians. Classical economists believe that wages and prices are quite flexible; in response to a change in market conditions, wages and prices adjust quickly to their new market-clearing levels. Keynesians believe that wages and prices are rigid or sticky; in response to changes in the economy, wages and prices adjust slowly to their new market-clearing levels.

(b) The importance of macroeconomic policies

Answer Classicals and Keynesians also disagree about the use of macroeconomic policies. Given wage-price flexibility, classical economists believe that the market economy normally provides for full employment. They believe that government intervention in the form of macroeconomic fiscal and monetary policies is not needed to prevent recessions. Given slow adjustments in wages and prices, Keynesians believe that recessions could plague the economy for several years. They believe that efficient use of macroeconomic policies could return the economy to equilibrium more quickly.

Question 2. In 1993, the debate heated up in the United States about the North American Free Trade Agreement (NAFTA), which proposed to reduce barriers to trade (such as taxes on or limits to imports) among Canada, the United States, and Mexico. Some people opposed strongly the agreement, arguing that an influx of foreign goods under NAFTA would disrupt the U.S. economy, harm domestic industries, and throw American workers out of work. How might a classical economist respond to these concerns? Would you expect a Keynesian economist to be more or less sympathetic to these concerns than the classical economist? Why?

Answer A classical economist might argue that the economy would work more efficiently with NAFTA because it reduces trade barriers, making the invisible hand work even better. Workers could specialize even more than before so that total output produced by all three countries would be more. Though the industrial mix might change in each country, wages and prices across industries would adjust quickly, and people in industries that closed down in a particular country would quickly find new jobs.

A Keynesian economist might be more sympathetic to concerns about NAFTA because of the belief that adjustment to the changes will not occur quickly. As a result, people in particular industries in a country may become unemployed. Wages won't adjust quickly to restore full employment, so some government action (like retraining programs to give displaced workers new skills) may be desirable.

Question 3. "Increased consumption of sugar is associated with increased rates of obesity. A tax on sugar content of foods would lead to decreased sugar consumption and lower obesity rates." Is this a positive or normative statement?

Answer As written both sentences are positive. The first is a positive statement of existing fact. The second is a prediction about positive fact (subject to empirical confirmation). The second sentence would be normative if it added the phrase "and should be imposed."

Question 4. Evaluate the following comments.

(a) Inflation is bad for everyone.

Answer This is a common misperception. This is not the case. Inflation reduces the value of money. Because of that, people who have borrowed money benefit from a higher inflation rate when they pay the money back. The interest rate that a borrower pays is effectively lower thanks to inflation.

(b) Inflation should always be avoided.

Answer This is another very common misperception. In fact, deflation has more serious damaging impact on an economy and is associated with particularly severe recessions and depressions. Hence, most policymakers agree that avoiding deflation is a far more important objective. As a result, the goal of policymakers is not zero inflation (inflation that is too close to zero runs the risk of becoming negative, and deflation becomes a possibility), but small and predictable inflation rates.

Question 5. Discuss the following two questions.

(a) The Lady of Wintersfell has borrowed \$2.5 million dollars from the Iron Bank of Bravodos which she promises to pay back in five years. During those five years there is unanticipated deflation across the kingdom. How does this deflation redistribute wealth between the borrowers and lenders? Explain.

Answer Unanticipated deflation hurts the Lady of Wintersfell (the borrower) and benefits the Iron Bank (the lender). The Lady of Wintersfell will see a decrease in her wealth as she must pay back the Iron Bank with money that is now worth more than she borrowed. The Iron Bank, on the other hand, will see their wealth increase as a result of the unanticipated deflation.

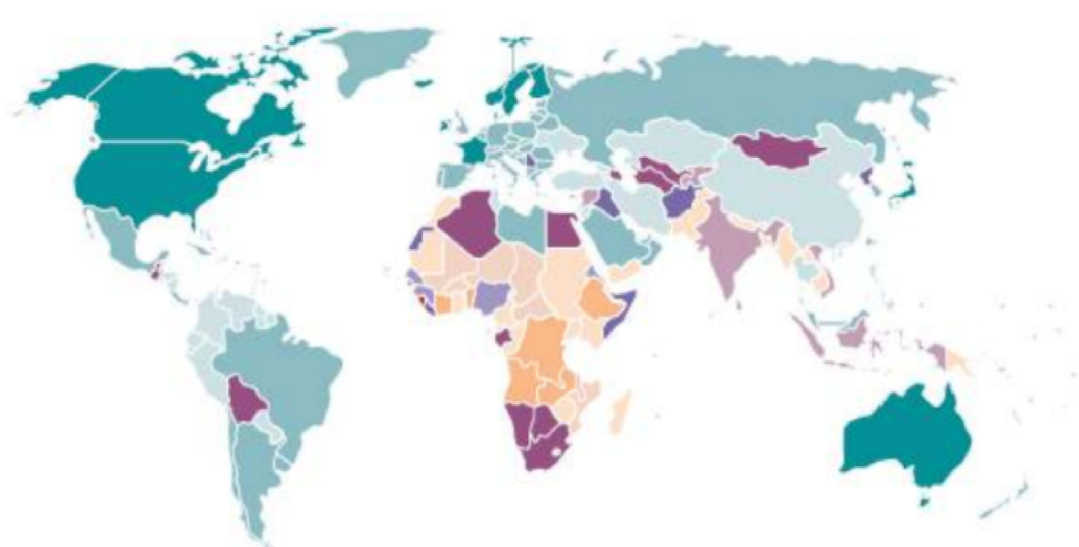
(b) You inherit a fortune of $100, which you place in a secure savings account that has a fixed interest rate. The inflation rate ends up being higher than you anticipated when you first placed your money in the bank. Does your expected wealth increase, decrease, or stay the same over time? Explain.

Answer The higher than anticipated inflation rate reduces your future wealth. Savers with fixed interest rates are worse off when inflation is higher than expected because effectively the value of interest income they earn is lower than what they thought it would have been based on expected inflation rates.

Question 6. Case Study: Problems in measuring GDP

When things are traded in a market, or embedded in government tax statistics, they are relatively easy to measure. Many of our measurement difficulties arise precisely because some of the most valuable things are not easily measurable. GDP easily captures the output of washing machines, but not of happiness, health or environmental depreciation. Since we do not buy and sell clean air or moderate temperatures in a marketplace, governments are not automatically collecting statistics for use in national accounts data.

The United Nations Human Development Index systematically tries to measure three broad dimensions of economic development - health, education and material standard of living – and produces annual statistics for all UN member countries. The map below shows the geographic range of outcomes – no prizes for guessing which colours represent prosperity and which represent poverty as measured by the Human Development Index.



Source: United Nations.

Health is crudely captured by life expectancy at birth, education by the proportion of the children enrolled at school and by the proportion of adults who can read, and material standard of living by per capita GDP.

Some of these indicators are more stable than others. For example, before the financial crash, Iceland came top in the world in the UN measure, and Sierra Leone bottom. But Iceland's banks experienced the biggest crash of all, and the Icelandic economy got into serious trouble. This did not immediately affect its adult literacy or the life expectancy of its population, but these will gradually suffer unless economic prosperity can be restored. Like sausages, economic statistics simply reflect what you put into them. If you care about democracy, equality or environmental sustainability, don't get hung up merely because your country is not doing well on the particular things that GDP does measure.

People who visit France quickly learn that the French have a good quality of life, better than you would expect simply by looking at their GDP. They enjoy a nice climate, long lunches, access to Mediterranean beaches and little congestion since they have plenty of land in relation to their population. They also retire at a relatively young age and, having long life expectancy, spend plenty of happy years in retirement. Their GDP statistics are measuring production of Renault and Peugeot, and of luxuries from Louis Vuitton and Hermès, but omit plentiful leisure, lack of stress and little congestion.

Similarly, the output of the police, civil service and teachers in schools is not charged for in the market and hence not automatically valued by the market. How do we measure the output of the police? Typically, national income statisticians measure the inputs (the wage bill of police forces, rent of police stations, the cost of using police cars and police computers).This is a large step in the right direction but it is far from perfect. If society becomes more unlawful, we end up choosing to have more police to counter crime.

So GDP rises because we are spending more on the police force. But in reality, people are feeling less happy with the greater prevalence of crime, and resent having to 'waste' more resources on additional policing in order to counter the crime wave. Conversely, when we cut back the size of the army, GDP falls since less is being spent on the military, but we are actually receiving less defence as a consequence. Think of all this as a health warning on GDP statistic. It measures what it measures. Unless and until electorates want to spend a lot more money collecting more comprehensive statistics, GDP will use data already being collected annually for other purposes such as taxation.

(a) Outline the main problems associated with determining national output (Gross Domestic Product, GDP).

Answer The gross domestic product of a country states the final value of all goods and services produced in a country and is viewed year on year as a measure to judge progress and growth in a country.

The issue with calculating a countries progress through the help of GDP does not tell us the social conditions of the country in question. For example, it is a known fact, that countries such as India has grown in GDP, however still a large part of the population is unable to manage 2 square meals for themselves which remains a larger problem than calculation of GDP alone.

A decline in GDP could be because of various factors as in the case of Iceland which experienced cyclical problems in the economy, but yet was able to sustain well on other measures such as health index, social equality, child labour etc.

Therefore, the problem with calculating GDP is that it does not consider qualitative elements as important while estimating the growth of a country. It only describes fall or rise in the value of final goods and services which in turn may be due to various causes and may not highlight social measures as illustrated above.

(b) Why is the United Nations Human Development Index often used?

Answer The core reason why Human Development Index is used often is the fact that, it takes a broader view of the economy and does not consider final value of assets or services to be the only consideration which determine the welfare of a country.

Emerging nations such as India may be able to grow itself at a higher rate when compared to the developed economy, yet they may encounter serious issues when it comes to the problems such as Health care administration, educational facilities, lack of critical care for the old, inequality of income distribution etc.

All these measures are well covered in the United Nations Human Development Index approach which considers both qualitative and quantitative techniques to describe growth within a country respectively. This further helps in assessing the situation of a country over the years and monitoring it with a broader perspective.

Conclusion to Parts 1 & 2 We can thus, conclude by saying that governments over the years have used GDP as the measure to describe growth but these statistics often fail to tell us the entire picture of the society. The society is more complicated and has different dynamics to it such as Healthcare, Education, Equality of income distribution etc. These need to be detailed and analysed for having both qualitative as well as quantitative approach towards human management. This highlights the importance of the Human Development Index approach followed by the United Nations in its assessment.