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

(a) The flexibility of wages and prices.

(b) The importance of macroeconomic policies

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?

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?

Question 4. Evaluate the following comments.

(a) Inflation is bad for everyone.

(b) Inflation should always be avoided.

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.

(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.

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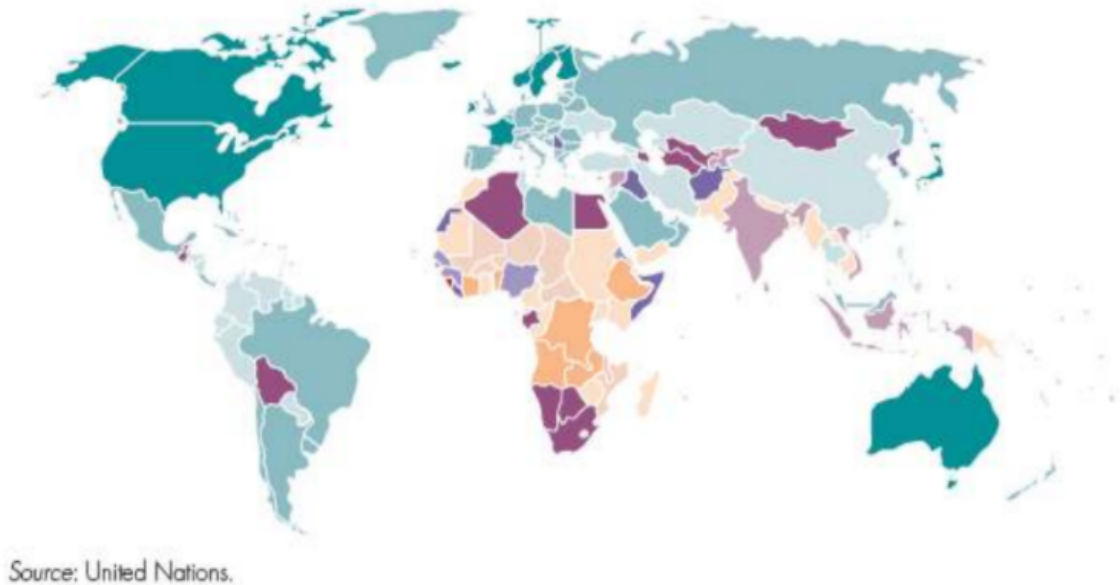
Health is crudely captured by life expectancy at birth, education by the proportion of the children enrolled at school and by the proportion of adults who can read, and material standard of living by per capita GDP.

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).

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