

Answers Mid-Term Examination
Econ 102 – 2010

I Multiple choice questions (green version first, red version second)

1. c. c
2. b. a
3. a. d
4. c. a
5. d. d
6. d. c
7. b. b
8. c. d
9. d. c
10. a. c
11. b. b
12. d. b
13. c. d
14. c. b
15. a. c
16. b. a
17. d. d
18. c. c
19. d. b
20. d. c
21. b. d
22. c. d

II Long questions (the order corresponds to the green version)

1. a. **John Maynard Keynes** (1883-1946) *John Maynard Keynes was a British economist during the first half of the 20th century best known for his revolutionary theories on the causes of unemployment and recession, which came to be known as Keynesian economics.*

Friedrich von Hayek (1899-1992) *Born in Austria in 1899, Nobel Prize-winning economist Friedrich von Hayek was an advocate of free-market capitalism. He is known for his criticism of the prevailing economic theories of the 20th century, Keynesian economic models and socialism.*

b. Keynes puts forward an economic philosophy (known as Keynesianism) calling for overspending, or "deficit spending," during an economic slowdown, and underspending, or creating budget surpluses, during times of too-rapid economic expansion.

In his book, *The General Theory of Employment, Interest, and Money* (1936), Keynes attacked the classical economics tradition because it rests on a fundamental error, that the balance between supply and demand would ensure full employment. On the contrary, in Keynes's view, the economy was chronically unstable and subject to fluctuations, and supply and demand could well balance out at an equilibrium that did not deliver full

employment. The reasons were inadequate investment and over-saving, both rooted in the psychology of uncertainty. Hence, the role of governments in time of crisis.

Keynes intended government to play a much larger role in the economy. His vision was one of reformed capitalism, managed capitalism -- capitalism saved both from socialism and from itself. Fiscal policy would enable wise managers to stabilize the economy without resorting to actual controls. The bulk of decision making would remain with the decentralized market rather than with the central planner.

Hayek places himself in the classical economic tradition. Philosophically, this implies a fundamental responsibility of individuals by their actions and choices. Collectively this implies that freedom should be a fundamental aspect of society and with it competition. Thus he is in favor of making the best possible use of the forces of competition as a means of coordinating human efforts. It is based on the conviction that, where effective competition can be created, it is a better way of guiding individual efforts than any other. It does not deny, but even emphasizes, that, in order that competition should work beneficially, a carefully thought-out legal framework is required and that neither the existing nor the past legal rules are free from grave defects. Competition is essential not only because it is in most circumstances the most efficient method known but even more because it is the only method by which our activities can be adjusted to each other without coercive or arbitrary intervention of authority (it dispenses with the need for "conscious social control" and that it gives the individuals a chance to decide whether the prospects of a particular occupation are sufficient to compensate for the disadvantages and risks connected with it).

Hayek's ideas are generally broad and the Chicago School is the one which adapted classical economic ideas to the 20th century economic conditions and by implication became the main opposition to the new Keynesianism by emphasizing laissez-faire -- free markets -- and argued against government intervention. Thus, prices are the best allocators of resources. Any intervention to change what markets, left alone, would achieve was likely to be counterproductive. The conclusions for government policy were clear: Wherever possible, private activity should take over from public activity. The less government did, the better. Intervention in the money supply distorted the markets; better instead to have a steady, predictable growth in the money supply. This was the very opposite of the Keynesian idea that government could smooth out economic fluctuations.

c. These ideas are important to understand the economic history of the 20th century because: (i) it helps understanding the push toward globalization at the beginning of the 20th century; (ii) the mistakes made to respond the economic crisis after WWI; (iii) the economic policies put in place to resolve the depression and after WWII; (iii) to understand the economic problems of the 1980s and 1990s.

More broadly these ideas show the perpetual tension between free capitalism and managed economies with its various excesses in both directions. The Chicago School -- and, more indirectly, Hayek's contribution -- proved crucial to a general shift in the center

of gravity of economic thinking and to a reevaluation of the appropriate balance of government and marketplace.

- d. In Friedman's words, "The role of people is to keep ideas alive until a crisis occurs. It wasn't my talking that caused people to embrace these ideas, just as the rooster doesn't make the sun rise. Collectivism was an impossible way to run an economy. What has brought about the change is reality, fact -- and what Marx called the inevitable forces of history."

The pendulum continues today with the recent economics crisis. By the end of the 20th century we had learned that fiscal management was no longer seen as an effective tool, higher inflation did not assure lower unemployment, but it did mean more uncertainty, smaller government was better as it was all too easy for big government to crowd out private activity. Thus, in contradiction to the received wisdom of Keynesianism, reducing deficits, rather than increasing them, could stimulate economic activity and thus Keynes was not a man for all seasons. Today we are rediscovering Keynes's wisdom, the role of governments, the necessity of deficits and of regulations at least in the financial sectors.

2. This question is directly from the lecture and the material below taken directly from one of the slides.

- Answer: No. The average wage level in a country is determined by the average productivity level. Productivity is largely determined **by technology**, organization of production, infrastructure. Thus, unless you think that trade will lower productivity there is no reason to believe that by trading more with low wage countries you will lower the average wage level in the economy.
- But it is true that if trade opens up with a low-wage country with which trade did not previously exist, some low productivity activities will be displaced from the high- to the low-income country.
- If the economy responds to this by moving people from low productivity sectors to high productivity sectors, the average level of wages will increase, not decrease.
- Therefore how labor markets respond to various changes becomes important.

3. This question is also directly from the lecture

- a. A preferential trade agreement is one which involves a small number of countries and which aims at removing trade restrictions among them. To be consistent with membership to GATT/WTO, these agreements must be free-trade agreements.
- b. There are two main types of preferential trade arrangements: **Free Trade Areas** (FTAs) and **Customs Unions** (CUs). The basic difference between FTAs and CUs is how member countries treat non-member countries. A CU is an association of countries that agrees to eliminate barriers to trade among its members and to form common barrier against non-member countries. Ex.: The European Union
A FTA is an association of countries that also agree to eliminate trade barriers between themselves, but they maintain their own individual trade barriers against non-member countries. Ex.: NAFTA