1.0 Course Overview

Consider the following issues:

a. During the 1990s, U.S. equity markets experienced an unprecedented bull market. If we look back over the last 120 years, there were three other periods in stock market history during which market participants drove stock prices up to extraordinary levels, only to be followed by very steep drops and movements back to sustainable levels. Such long-swing movements occurred during the 1890s, the 1920s and the decade beginning in 1955. One way to judge the level of stock prices is to look at what are called price-earnings (P/E) ratios.

In June 1901, the P/E ratio for the S&P basket of stocks reached 25.2, which means that the price of a share was 25.2 times larger than earnings per share. At that time, a P/E ratio of 25.2 was a historical record. To give you an idea of how high this was, the 120 year historical average for the P/E ratio is 14. If we use this level as our benchmark (“fair”) level, then in June 1901, stocks were overvalued by 79%! In June 1929, the P/E ratio reached 32.6, which was a record that stood until the 1990s. In January 1966, the P/E ratio reached a high of 24.1. Subsequent to these three periods of historic highs, the stock market experienced market declines (bear markets) over the following 10 years. So from 1901 to 1911, stock prices fell 80%, from 1929 to 1939, stock prices fell 58% and between 1966 and 1976, stock prices fell 67%.

Now for the 1990s. By March 2000, the P/E ratio reached 44.3! Based on our historical benchmark, stocks were overvalued by 216% at that time. Since then, stock prices have come down, reaching a bottom in February 2003, corresponding to a P/E ratio of 21.2. Since then, stock prices and earnings have increased. But the rise in stock prices has been larger, leading to a P/E ratio of 26.4 as of June 2004. Clearly there is a lot more room for stocks to fall. According to the historical record, we should expect a bear market for the next ten years.
Will this happen? Why do stock prices undergo long swings away from benchmark levels? What role do equity and other financial markets play in our economy? What impact would a sustained bear market have on our economy? Is there anything George Bush can do to help? Should we allow Social Security Trust Funds to be invested in the stock market?

b. According to the NBER, the U.S. economy came out of its last recession in the fourth quarter of 2001. But U.S. growth rates in GDP did not really pick up until 2003. And despite the positive growth, the U.S. economy has begun in the last year to produce a significant number of jobs.

Why do recessions occur in capitalist economies? Are they predictable? Did Bill Clinton or George W. Bush have anything to do with the U.S. economy slipping into recession in 2001? Were Bush’s tax cuts the key to getting the U.S. economy growing again? Will the U.S. economy continue to grow for the foreseeable future? Why has job growth lagged so much? Are the Democrats right in arguing that the Bush tax cuts are to blame?

c. Between 1970 and 1992 the personal savings rate (total household saving/personal income) in the U.S. fluctuated in a range of 8-12%. Starting in the early 1990's, the personal saving rate began to fall steadily. As of the first half of 2000, the personal saving rate was essentially zero, i.e., U.S. households consumed all of their income. Over the same period, household debt increased from 85% of personal income in 1992 to more than 100% in 2003.

Is this a problem for the U.S. economy? Can the U.S. economy continue to thrive with a zero personal saving rate and rising debt? Will the personal saving rate eventually revert back to its historic average of 8%? What would this imply for the U.S. economy over the next five years?

d. As of May 2001, the nonpartisan Congressional Budget Office (CBO) forecasted that the overall cumulative surplus in the federal budget would be $5.6 trillion over the following 10 years, while the on-budget surplus (i.e., the surplus excluding Social Security) would reach $3 trillion over the next decade. As of September 2004, the CBO no longer projects budget surpluses. Rather they now project deficits over the next 10 years of over $3.8 trillion. Most nonpartisan think tanks project even larger deficits over the next 10 years of over $5 trillion. Starting in 2010 the ratio of population aged 65+ to working age population will rise from .2 to over .35 by 2045. This increase implies huge future outlays for social security and medicare. Consequently, many nonpartisan think tanks are projecting deficits as far as the eye can see.

How reliable are the CBO forecasts? Why do they change so much? Are the Democrats right in arguing that the growing debt is a big problem for the U.S. economy? Are Democrats right in wanting to repeal some or all of Bush's tax cut? Do we really need deficit reduction? Is Social Security a ticking time bomb? What are the implications for the long-run health of the U.S. economy?

e. One of the fundamental questions of economics concerns the factors behind the incredible growth experience of the "developed" or OECD countries and why there so many countries that have not figured out how to grow. For example, per capita RGDP in the U.S. grew by a factor of 9.2 from $2810 in 1870 to $25890 in 1998. Between 1950 and 1998 U.S. real income per capita more than doubled. Based on these numbers, the U.S. is the richest country in the world.
Why? What did we do right and others countries do wrong? Should we give the U.S. presidents of the last century credit for this performance? What can policy officials do to ensure high long-run growth rates in the future? Why are there so many countries who have not been able to grow? Why are their more than a billion people who live on less than one dollar a day? Does growth in the industrialized world help or hurt growth prospects in the developing world?

Objectives

The foregoing will be just some of the issues we will study this semester. I have four main objectives for this course. First, I want to spark your interest in macroeconomics. Second, I want you to learn enough macroeconomics so that you can talk sensibly about the foregoing issues. Third, I want you to be able to assess the economic programs of the Democratic and Republican parties. Finally, I want you to become familiar with retrieving and analyzing economic data and information from the internet.

2.0 Reading Materials

Required:


Recommended

A one-semester subscription to the *Wall Street Journal*

3.0 Prerequisites

Principles of Macroeconomics and curiosity

4.0 Grading

**Exams:** There will be three intra-term exams, each worth 20% of your final grade and one final exam, worth 30% of your final grade. All students *must* take all four exams to pass the course. Makeup exams are given, but only under the following conditions: 1) a student contacts me prior to the time of the exam; 2) a student has a legitimate excuse for missing the exam and can substantiate sufficiently any claim; and 3) if the excuse is poor health, a student *must* present written confirmation of their poor health from the health center or a certified doctor.

**Homework:** Homework problems will be assigned, collected and graded every week. These assignments will count 10% towards your final grade. In addition to working on the ideas and concepts taught in class, the homework will also ask students to become familiar with
logging onto the web and retrieving and analyzing data from popular data bases. Students who do not hand in a homework assignment on time will be given one extra class period in which to do so. However, a late penalty will be deducted from all late homework assignments. Homework assignments not handed in either on time or one class period late will not be accepted.

5.0 Food for Thought

The following three unproven propositions are offered for rumination:

Proposition 1: Of the people borne into this world, some will develop exceptional brilliance while others will remain incredibly inept. But the overwhelming majority are, at first, remarkably similar in their intellectual capacity as generally understood.

Proposition 2: Of the overwhelming majority, the difference between those who are "smart" and those who are "slow" stems from the former training their minds to think (whether creatively or analytically, whether deliberately or accidentally); whereas the latter put forth relatively little effort in this regard.

Proposition 3: The greatest inefficiency in our world economy has been and continues to be the billions of minds that enter and leave this world untrained.

6.0 Outline

Chapters denoted by a star "*" will receive only cursory treatment in class and are to be read at home. Students should not be misled, however, into thinking that these starred chapters are unimportant. On the contrary, students will be asked to know the material covered in these chapters on exams. The figures appearing in parentheses indicate the approximate amount of class time that will be spent on each chapter (½ week = 1 lecture).

6.1 Introduction

Chs: 1. A Tour of the World (½ week)*
     2. A Tour of the Book (1 week)

6.2 The Core

The Short-Run

Chs: 3. The Goods Market (1 week)
     4. Financial Markets (1 week)
5. Goods and Financial Markets: The IS-LM Model (1½ weeks)

NOTE: THE FIRST INTRA-TERM EXAM WILL BE GIVEN OUTSIDE OF CLASS ON TUESDAY, FEBRUARY 22ND AND WILL COVER CHAPTERS 1 THROUGH 5.

The Medium Run

Chs: 6. The Labor Market (1½ weeks)
7. Putting All Markets Together: The AS-AD Model (1 week)
8. The Phillips Curve (1 week)

NOTE: THE SECOND INTRA-TERM EXAM WILL BE GIVEN OUTSIDE OF CLASS ON TUESDAY, MARCH 29TH AND COVER CHAPTERS 6 THROUGH 8.

The Long Run

Chs: 10. The Facts About Growth (½ week)
11. Saving, Capital Accumulation, and Output (1 week)
12 Technological Progress and Growth (1 week)

NOTE: THE THIRD INTRA-TERM EXAM WILL BE GIVEN OUTSIDE OF CLASS ON TUESDAY, APRIL 19TH AND COVER CHAPTERS 10 THROUGH 12.

6.3 Extensions

Expectations

Chs: 14. Expectations: The Basic Tools (1 week)
15. Financial Markets and Expectations (1 week)

6.4 Back to Policy

Chs: 25. Fiscal Policy: A Summing Up (1 week)