1.0 Course Overview

This is a very exciting time to be studying economics. The last three decades have given rise to incredible changes. Consider the following:

a. During the 1990's and the beginning of 2000, the U.S. economy experienced its longest economic expansion ever. During this period the U.S. economy produced record increases in new jobs, labor productivity and personal income. But by the middle of 2000, the U.S. economy was in a recession, a period of time during which the value of all the goods and services produced by domestically (which we call Gross Domestic Product or GDP) falls. Although the recession was officially pronounced over by 2001, the U.S. economy has yet to show strong signs of growth. Why did the U.S. economy grow so strongly for so long in the 1990s? Should we credit the economic policies of Bill Clinton for this performance? Why did the U.S. economy fall into a recession in 2000? Why has the economy continued to flounder since 2001? Should we blame the economic policies of George W. Bush for this performance? What lies ahead in the near future? What kind of job, if any, will there be for you when you graduate?

b. Additional record performers during the 1990s were U.S. equity markets, which reached unprecedented levels by March 2000. If we look back over the last 120 years, there were three periods in stock market history that can be identified as involving bubbles, periods during which market participants drive stock prices up to extraordinary levels, only to be followed by very steep drops and movements back to sustainable levels. Such bubble movements occurred during the end of the 1890s, the end of the 1920s and the first half of the 1960s. One way to judge the level of stock prices is to look at what are called price-earnings 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 25.2 P/E ratio was a fantastic 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 consider the 1990s. By March 2000, the P/E ratio reached 44.3! Based on our historical benchmark, stocks were overvalued by 216%. Since then, stock prices have come down. This past year has witnessed a strong rebound in stock prices. Will the rally continue? Despite the rebound, the P/E ratio as of August 2003 is still close to 25. Clearly there is much room for stocks to fall. According to the historical record, we should expect a bear market for another eight years. Will this happen? 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 W. Bush can do to help? Should we allow Social Security Trust Funds to be invested in the stock market?

c. Between 1915 and 1980, the federal government borrowed net, roughly $600 billion, i.e., as of 1980 the national debt stood at about $600 billion. At the end of 1992, the national debt stood at $4.6 trillion! According to former U.S. Senator Paul Tsongas, "By the time my children are in the prime of life, every penny of federal taxes will be used in only two places - interest on the debt and entitlement programs. Nothing else. No Army, Navy, Air Force or Marines, no FBI, no federal prisons, no Supreme Court, no bridge repairs, no meat inspectors, no college loans, nothing else." But beginning in 1993, under Bill Clinton, the U.S. federal deficit began to decline and by 1998 the U.S. federal government started running budget surpluses for the first time since the 1950s. As such the national debt began falling. It appeared as though the debt problem had been solved. Is a national debt of close to $5 trillion a problem for the U.S. economy and should credit be given to Bill Clinton for getting the federal budget back to fiscal soundness? Unfortunately, beginning in 2002, the U.S. federal government began once again to run unprecedented budget deficits. Under realistic assumptions about George W. Bush’s economic policies and the future course of the economy, the future deficits are projected to equal almost $6 trillion dollars over the next 10 years. Is this a problem for the U.S. economy? Is Senator Tsongas’s forecast starting to look reasonable again? Should we blame George W. Bush’s economic policies for this situation? Should the federal government be taking steps now to head off a possibly disastrous situation of runaway debt?

d. The Republicans had a sweeping victory in the 1994 off-year congressional elections, and they have been able to solidify their gains in almost every election since. To a large extent these electoral victories were a victory in the struggle over economic ideas. The Republicans believe that Americans are taxed too much and that the federal government is too big and too pervasive. Is this true? George W. Bush argued in the 2000 presidential election that the American taxpayer needed and deserved a large tax cut. He argued that 2000 was a perfect time for such policies because the federal government was projected at that time to run budget surpluses for the next ten or fifteen years. Congress agreed and two major tax cuts, totaling $1.3 trillion and $.8 trillion over ten years respectively, were signed into law 2001 and 2003. Of course, now, just three years later, the federal budget is no longer projected to be in surplus for 10 years, but rather in deficits of unprecedented magnitudes. Many of the Democratic presidential candidates will come to NH and argue that the Bush tax cuts need to be rolled back. Is this good economic policy? George W. Bush and the
Republicans will come to NH and tell you that what the Democrats really want to do is raise your taxes to pay for wasteful government programs, and that the tax cuts of 2001 and 2003 are still required to get the economy going again. Is this true? Which party should we believe?

e. One of the fundamental questions of economics concerns the factors behind the incredible growth experience of the “developed” or OECD countries during this century, and why there are so many “developing” countries that have not grown over this period and seem doomed to experience no growth as far as the eye can see. 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. 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? What can policy officials do to ensure high long-run growth rates in the future? Why are there so many countries that 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?

These are just some of the questions we will be examining this semester. In order to talk intelligently about them we need to develop ideas and conceptions about how the economy works. This is where theory and science come in. The world is terribly complex and our human minds are too small to understand the world in all of its complexity. In order to deal with the complexity, scientists simplify and focus on only the most relevant of relationships. Theories are nothing else than a number of simplifications or assumptions put together in order to help us make sense of how the world works. Believe it or not, with just one semester of studying economics, you will obtain a rather good grasp of all of the foregoing issues and more!

2.0 Reading Materials

Required:


3.0 Prerequisite

Curiosity

4.0 Grading
All students are required to take three intra-term exams (each worth 20 points toward your final grade) and one cumulative final examination (worth 40 points toward your final grade) in order to receive a passing grade for the course, i.e., all students must take four exams to pass the course. Makeup exams are given, but only under the following conditions: 1) The student contacts me prior to the time of the exam; 2) The student has a legitimate excuse for missing the exam and can substantiate sufficiently any claim; and 3) If the excuse is poor health, the student must present written confirmation of such poor health from the health center or a certified doctor.

In addition to the four exams, there will be between 10 and 13 short, in-class, quizzes during the semester. Your performance on the quizzes will earn you points that will be added directly to your total score for the semester. If you score 100% on all quizzes, then I will add 10 points to your final score. (Equivalently, this means that I will add 50 points to your first intra-term exam!) If your average score on the quizzes is 90%, then I will add 9 points to your final score, with lower quiz averages leading to symmetrically fewer total points. Quizzes will be unannounced, so students need to come to class prepared.

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 defined.

**Proposition 2:** Of the overwhelming majority, the difference between those who are “smart” and those who are “slow” stems from the fact that the former train 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 and national economy has been and continues to be the billions of minds that enter and leave this world untrained.

6.0 Outline

The 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 Getting Acquainted with Economics

Chs: 1*. What is Economics?
2. Scarcity and Choice: The Economic Problem (2/3 week)
3. Supply and Demand: An Initial Look (1 week)

6.2 The Macroeconomy: An Introduction to Some of the Issues

Chs:  
4. The Realm of Macroeconomics (1 week)
5. The Goals of Macroeconomic Policy (2/3 week)

NOTE: The first intra-term examination will cover chs. 1 through 5 and will be given on TUESDAY, September 30th, CLASSROOM TO BE ANNOUNCED.


6.3 Aggregate Supply and Demand Analysis

A. Building a Simple Model of the Economy

Chs:  
7. Aggregate Demand and the Powerful Consumer (1 week)
8. Demand-Side Equilibrium: Unemployment or Inflation? (1 week)

B. Relaxing the Assumptions of the Simple Model

Relaxing the Assumption of Fixed Prices: Adding an Upward Sloping Aggregate Supply Curve

Chs:  

NOTE: The second intra-term examination will cover chs. 6 through 9 and will be given on THURSDAY, October 30th, CLASSROOM TO BE ANNOUNCED.

10. Managing Aggregate Demand: Fiscal Policy (2/3 week)

2. Relaxing the Assumption of Fixed Interest Rates: Adding in the Monetary Sector

Chs:  
11. Money and the Banking System (1 week)
12. Monetary Policy and the National Economy (1 week)

3. Adding in the International Sector

Chs:  
17. The International Monetary System: Order or Disorder? (1/3 week)
18. Macroeconomics in a World Economy (2/3 week)

NOTE: The third intra-term examination will cover chs. 10 through 12 and chapters 17 and 18 and
will be given on TUESDAY, November 25th, CLASSROOM TO BE ANNOUNCED.

6.4 Discussing Some of the Major Issues in Economics

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<th>Chs.</th>
<th>14. Fiscal Policy, Monetary Policy, and Growth (1 week)</th>
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<td>17. Inflation and Growth: The Phillips Curve (1 week)</td>
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