PRINCIPLES OF ECONOMICS

Spring 2015

Instructor : *Bertrand de Largentaye*

Time : *4 P.M. to 7 P.M.*

Office Hours: *By appointment*

Office Location: *6th Floor*

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Text Book: *Economics (second edition) by* ***N. Gregory Mankiw and Mark P. Taylor***

The Economist: *Weekly reading of the business section of* The Economist *is strongly recommended*

Course Description and Objectives

Do economics really live up to their reputation as the "dismal science", as Carlyle and Malthus would have it? There are reasons to think otherwise, despite past and more recent trends to elaborate sophisticated mathematical models, the main feature of which has seldom been to give a more accurate picture of reality, notwithstanding claims to the contrary. Students will be made aware that many issues are still disputed, but they will also be led to appreciate the progress that has been made in devising appropriate economic policies, through trial and error, but also because of the advancement of economic theory. The course will strive to give a sense of the history of economic thought, not excluding assessments of the harm failed or flawed economic policies have brought about. It will insist on the need for clear and accessible definitions and for rigorous analysis.

The limited time available will invariably have an effect on the nature of the course: as we will be covering a pretty wide variety of material, we will not be able to dig into some of the topics as much as a deeper understanding of them would warrant; hence the idea that this is more of an introduction, or of an overview, of the principles of economics, than a full-bodied course.

Among the objectives of this course, one should perhaps start by mentioning the need to get the students acquainted with the tools used for economic analysis and reasoning. Another would be to get them to become familiar with a number of rival schools of economic thought, and with the circumstances that led to their emergence and development. This should lead them to appreciate President Truman's famous disabused remark on his search for a one-armed economist who would not be able to avoid committing himself by arguing "on the one hand….but on the other…." A third objective would be to prepare at least some of the students for another AGS course, on economic policy.

The purpose of economics is to determine the circumstances under which scarce resources can be optimally allocated and people's well-being maximized. This economics course will be broken down into three parts, micro-economics, macro-economics and international economics. Each one of the three parts will be subdivided into chapters, with the number of chapters adding up to twelve.

Grading Policy

Each student's final grade will be a composite figure, broken down as follows, with the weights attached to the different components in parentheses:

Attendance (10%)

Each student is expected to come on time and stay for the duration of the class. If a student misses a class, it is his/her responsibility to catch up on notes and materials taken or distributed during his absence. If the student misses class on a day when an exam or proposition is scheduled, s/he will not be allowed to retake the exam unless s/he has a doctor's certificate or other valid reason justifying his/her responsibility.

Participation (25%): leading a class discussion (20%) and taking part in it (5%)

On February 3, each student will be assigned two topics related to the course. S/he will be expected to lead a discussion on these topics on one or two specified days. This will take the form of a fifteen minute presentation; the main points of this presentation will be set out on a single sheet of paper which will then be handed over to the instructor. Typically the student leading the discussion will make some theoretical or fairly abstract points to begin with, and then relate his findings to real life situations, before opening the floor by asking a few relevant questions. All students will be expected to have satisfied their reading requirements. After the *presentation and during the discussion, the instructor will raise questions to make sure that this is so. Students are encouraged to ask for the floor if they find they need clarifications on points made by the instructor during the course of his lecture.*

Midterm exam (30%)

The midterm exam will take place on March 24, before the spring break. It will be an in-house exam lasting an hour and a half and will relate to the ground covered by the course up to, and including, March 17.

Final exam (35%)

The final exam will take place on May 26 and will relate to the entire course.

Course Management

The twelve chapters will be covered in twelve three-hour sessions, with each session focusing on a specific and different chapter. Students will be expected to be familiar with the pages of their textbook dealing with the subject matter of each successive chapter before attending the relevant lecture.

Cell phones will not be available during class time.

If students choose to record a given session, they must ask permission from the professor.

Students whose disruptive behavior persists after being warned will be asked to leave the class.

Regardless of the quality of work, plagiarism is punishable with a “failing grade” in the class and possible expulsion from the program. Plagiarism may be broadly defined as copying of materials from sources, without acknowledging having done so, claiming others’ ideas as one’s own without proper reference to them, and buying materials used as essays/exams.

Course Content

I. Micro-economics, also known as price theory, deals with choices made by individuals and individual firms

A. A selection of basic economic concepts

1. markets: - balancing supply and demand (the crossing of the supply and demand curves determines an equilibrium price)

- *the market as a way of allocating resources rationally (Adam Smith's invisible hand); the demise of central planning as an alternative resource allocation mechanism in 1989*

2. *elasticity*

3. *opportunity cost*

4. *productivity: -total factor productivity(the efficiency with which labor and capital are used)*

   -improving factor productivity as the only way of obtaining sustainable growth

   -total factor productivity (TFP) is difficult to measure: economists get at TFP by subtracting the change in capital and labor deployed from the change in overall output; the difference (known as the Solow residual, after Robert Solow, the economist who pioneered this method) reflects the contribution of productivity to growth

5. *diminishing returns v. economies of scale; the marginal efficiency of capital; average cost as and marginal costs*

   -the incremental capital-output ratio (ICOR), a measure of how much investment it takes to achieve each percentage point of growth; Japan, South Korea and Taiwan during their high growth phases featured ICORs of 2.7-3.2

6. *externalities*

7. *flows and stocks*

B. Competition and its distortions: the interaction of competing firms on the market

1. *perfect competition*

2. *imperfect competition*

3. *monopolies*

4. *monopsonies*

5. *oligopolies*

6. *regulation and, more specifically, anti-trust regulation in the United States and Europe*

7. *game theory and the prisoners' dilemma*

8. *the logic of collective action*

C. The factors of production and the production function

1. *capital and labor, the two main factors of production, and the residual factor (innovation?)*

2. *the Cobb-Douglas production function*

3. *indifference curve analysis*

4. *the Pareto optimum (a Pareto-optimal principle will endorse an action that makes no one worse off and one person better off)*

D. *The transition from micro- to macro-economics, from the individual firm or person to the aggregate*

1. *the propensity to save, the propensity to consume and the multiplier (the impact of a variation in the propensity to save on output: deleveraging, the reduction of the ratio of debts to assets, or, put more simply, the lightening of debt burdens, by increasing the propensity to save, is definitely a headwind from an output point of view)*

2. *Mandeville's Fable of the Bees*

3. *inequality and the propensity to consume; the poor consume a greater part of their income than the affluent and, consequently, promoting equality, by raising the average propensity to consume, can be seen as a way of promoting demand and employment*

II. *Macro-economics, the study of governmental fiscal, monetary, and employment policies*

A. *Reasoning in the aggregate*

1. *the two macro-economic tools at the government's disposal: fiscal and monetary policy*

2. *national accounts: measuring national output and national income*

3. *income as the sum of savings and consumption, and output as the sum of capital goods (investment) and consumer goods; since income and output are equal, being, as it were, opposite sides of the same coin, and since, provided unsold consumer goods are considered an investment, consumption is equal to the production of consumer goods, it follows that investment and savings must also be equal*

4. *macro-economic goals: full employment and price stability (balancing the current account should also be seen as a major macro-economic policy goal)*

B. *The classics, Keynes, the neo-classics and the monetarists*

1. *the classics (names) and their unacknowledged premises of full employment and a commodity monetary standard, from which all their teaching derives; savings, investment and the interest rate as seen by the classics*

2. *Keynes's focus on demand management, on the non-existence of a full employment equilibrium and on the implications of a fiat currency; the trade-off between unemployment and inflation (NAIRU – the non-accelerating inflation rate of unemployment - and the Phillips curve)*

3. *the neo-classics and the monetarists (the demise of the idea that markets are self-regulating, one of the central tenets of neo-classical economics and, more specifically, that financial markets, like any other markets, are inherently self-correcting, and best left to work freely for themselves); the belief of the Chicago school monetarists that fluctuations in the money supply determine the rate of inflation, from which Milton Friedman developed the monetarist technical prescription that the money supply should be controlled to curb inflation; in 1963 Milton Friedman and Anna Schwartz published "A Monetary History of the United States" which argued that misguided monetary policy helped entrench the Great Depression; the standard five market general equilibrium aggregate model; neo-classical macro-economics and the rational expectations hypothesis*

C. Specialized branches of macro-economics

1. *welfare economics (The Economics of Welfare, 1920, Arthur Pigou)*

2. *development economics: capital should flow from countries where it is relatively abundant, with a low marginal productivity, such as the United States, to countries where it is relatively scarce, with a high marginal productivity, such as China (yet what we have been witnessing in this country over the past decades is the* exact *opposite); Prebisch and import substitution; development economics as a variant of keynesian economics – economic modernisation by way of modern heavy industry and manufacturing industries set up, often with foreign loans or investment, behind high protective walls and with highly regulated internal markets; it was advocated for and widely applied in developing economies (and, in adapted form, in New Zealand)*

3. *supply side economics (Laffer)*

4. the economics of "shocks"

D. The meaning of money

1. barter and monetary exchange as a step forward

2. the quantity theory of money

3. *fiat* currencies as opposed to commodity currencies; the endogenous nature of money under a *fiat* currency (Keynes addressing the Macmillan Committee in 1930)

4. under a *fiat* currency, loans make deposits, rather than the other way round; under a *fiat* currency, if all bank loans were repaid, the currency would disappear; debt is the essence of our currency and the German attitude towards monetary issues may have something to do

with the fact that the German word for debt (*schuld*) also means sin; quantitative easing and its meaning: central banks often announce their asset purchasing plans in terms of a desired increase in the quantity of bank reserves

5. inflation and deflation; money and the banking system; deflation as resulting from a major increase in the propensity to save; deflation, by raising the value of a unit of money in terms of other goods, in effect increases the cost of borrowing

6. money as liquidity; classifying assets according to their liquidity; the liquidity preference

7. short and long term interest rates, the role of the central bank as a lender of last resort (in Europe and in the United States) and the Bank of International Settlements (BIS) in Basel as the central bank of central banks; since 1988 a committee of central bankers and supervisors meeting in Basel has negotiated international rules for the minimum amount of capital banks must hold relative to their assets

8. nominal and real prices

E. Savings and investment

1. it's investment that determines savings rather than the other way round; (private) investment is itself determined by the marginal efficiency of capital and the interest rate

2. Keynes's prediction that investment would have to be gradually socialized in order to satisfy a wealthier community's increasing propensity to save

3. increasing the balance of your bank account is not a way to increase aggregate savings.

III. International economics (countries interacting with one another) and international economic institutions

A. The balance of payments and the terms of trade

1. the trade balance and the terms of trade

2 the current account (a current account surplus as an indicator of a country's competitiveness)

3. the capital account (a capital account deficit as the statistical counterpart, or mirror image, of a current account surplus)

B. International monetary cooperation

1. optimum currency areas (in an influential paper published in 1961 Robert Mundell of Columbia University set out a set of tests for shared currencies; in an optimal currency area

the factors of production – capital and labor – must be able to move freely); current account imbalances do matter in a monetary union

2. Bretton Woods (1944) and its demise on August 15, 1971 (the end of a system of fixed, though adjustable, exchange rates); setting up the IMF and the IBRD; capital controls (cf. July 5 and December 13, 2014 issues of "The Economist"); the trilemma

3. shortcomings of the international monetary system (Involuntary Foreign Lending by Fritz Machlup)

4. Chinese central bank governor Zhou's prescriptions

5. the curse of today's asymmetrical corrective mechanism

6. the extraordinary advantage related to issuing the world's premier reserve currency

C. International trade theory

1. Free trade and mercantilism (David Hume and Adam Smith were intellectual influences in the struggle against mercantilism – state control of trade – and the rise of *laissez-faire* and the free market in the nineteenth century)

2. Ricardo and the law of comparative advantage. Let us consider two countries producing the same two goods; the cost of producing one good is a given fraction of the cost of producing the other good in the first country; in the other country that fraction is different, say it is higher, so that the cost of producing the first good is higher in terms of the cost of producing the second. That means the first good is comparatively cheaper, in terms of the second, in the first country, and that in turn means both countries should specialize their production, forgetting about the second good in the first country, and forgetting about the first good in the second country, and then trade in order to obtain the necessary quantities of the good they do not produce.

3. the GATT and the WTO

Course Calendar

February 3

Introductions (instructor and students)

General overview of the course + emphasis on interactiveness + grading policy, including a reference to the midterm and final examinations (dates and material to be reviewed)

Designation of discussion leaders + reading requirements for all

February 10

Microeconomics: a selection of basic economic concepts

Reading requirements: “Economics” (second edition) by N. Gregory Mankiw and Mark P. Taylor (henceforth M&T), part I, I, p. 6, 11, 12, 18

part I, 2, p. 31, 40

part 2, 4, p. 68-93

part 2, 5, p. 94, 95, 103, 104

part 4, 10, p. 198-220

part 5, 13, p. 275, 279, 283

part 9, 25, p. 536

Discussion topics: balancing supply and demand

externalities

February 17

Microeconomics: competition and its distortions – the interaction of competing firms on the market

Reading requirements: M&T, part 4, 11, p. 224

part 5, 15, p. 308, 311, 312

part 5, 17, p. 355, 364

Discussion topics: an outline of Joan Robinson’s “The Economics of Imperfect Competition”

an outline of Mancur Olson’s “The Logic of Collective Action” (how to deal with free riders)

February 24

Microeconomics: factors of production and the production function

Reading requirements: M&T, part 5, 13, p. 269

part 6, 18, p. 383, 384

part 7, 21, p. 441

Discussion topic: Pareto optimality

March 3

Microeconomics: the transition from micro to macroeconomics, from the individual person od firm to the aggregate

Reading requirements: M&T, part 12, 33, p. 709

Discussion topic: an outline of Thomas Piketty's "Capital in the XXIst Century"

March 10

Macroeconomics: reasoning in the aggregate

Reading requirements: M&T, part 8, 23, p. 489, 492, 496, 497

part 9, 26, p. 560

part 12, 34, p. 726 – 747

part 12, 35, p. 757 – 772

Discussion topics: monetary and fiscal policies, the two macroeconomic tools at the government's disposal

macroeconomics as a way of reasoning in aggregate terms

March 17

Macroeconomics: the classics, Keynes, the neo-classics and the monetarists

Reading requirements: M&T, part I, I, p. 12, 15 part 12, 36, p. 782 – 797, 804

Discussion topic: Say's Law

March 24

Macroeconomics: specialized branches of macroeconomics

Reading requirements: M&T, part 3, 7, p. 138

part 12, 36, p. 797

Midterm examination

April 14

Macroeconomics: the meaning of money

Reading requirements: M&T, part 1, 1, p. 14

part 8, 24, p. 507 – 509

part 10, 29, p. 618, 619, 621, 624 – 626

part 10, 30, p. 646 – 649

part 12, 35, p. 758

Discussion topics: an outline of W.W. Rostow's "The Stages of Economic Growth" (1960)

Singapore: moving up the value-added scale (development policy at its most successful?)

April 21

Macroeconomics: savings and investment

Reading requirements: M&T, part 12, 33, p. 707

Discussion topic: how do savings relate to economic growth?

April 28

International economics and international economic institutions: the balance of payments and the terms of trade

Reading requirements: M&T, part II, 31, p. 667

Discussion topic: the balance of payments as an external constraint, with references to the United States and to the European Union

May 5

International economics and international economic institutions: international monetary cooperation

Reading requirements: M&T, part 13, p. 849 – 857, “The Economist”, articles on capital controls in the issues of July 5, 2014 and of December 13, 2014

Discussion topic: the pros and cons of capital controls

May 12

International economics and international economic institutions: international trade theory and practice

Reading requirements:

Discussion topics: the transatlantic trade and investment partnership

autarchy

May 26

Final examination

The instructor reserves the right to change readings and contents of this syllabus.

Updated on Friday, 30 January 2015