

That Freshman Course Won't Be Quite the Same

By N. GREGORY MANKIW

MY day job is teaching introductory economics to about 700 Harvard undergraduates a year. Lately, when people hear that, they often ask how the economic crisis is changing what's offered in a freshman course.

They're usually disappointed with my first answer: not as much as you might think. Events have been changing so quickly that we teachers are having trouble keeping up. Syllabuses are often planned months in advance, and textbooks are revised only every few years.

But there is another, more fundamental reason: Despite the enormity of recent events, the principles of economics are largely unchanged. Students still need to learn about the gains from trade, supply and demand, the efficiency properties of market outcomes, and so on. These topics will remain the bread-and-butter of introductory courses.

Nonetheless, the teaching of basic economics will need to change in some subtle ways in response to recent events. Here are four:

THE ROLE OF FINANCIAL INSTITUTIONS Students have always learned that the purpose of the financial system is to direct the resources of savers, who have extra funds they are willing to lend, to investors, who have projects that need financing.

The economy's financial institutions — banks and insurance companies, for example — are mentioned as part of that system. But after a brief introduction in the classroom, they quickly fade into the background and are examined in detail only in more advanced courses.

The current crisis, however, has found these financial institutions at the center of the action. They will need to become more prominent in the classroom as well.

Financial institutions are like the stagehands who work behind the scenes at the theater. If they are there doing their jobs well, the audience can easily forget their presence. But if they fail to show up for work one day, their absence is very apparent, because the show can't go on. The process of financial intermediation is similarly most noteworthy when it fails.

THE EFFECTS OF LEVERAGE Not long ago, I was explaining to a freshman that the economic crisis arose because some financial institutions had, in effect, invested in housing by holding mortgage-backed securities. When housing prices fell by about 20 percent nationwide, these institutions found themselves nearly insolvent.

But the student then asked an important question: "If housing prices have fallen only 20 percent, why did the banks lose almost 100 percent of their money?"

The answer was leverage, the use of borrowed money to amplify gains and, in this case, losses. Economists have yet to figure out what combination of mass delusion and perverse incentives led banks to undertake so much leverage. But there is no doubt that its effects have played a central role in the crisis and will need a more prominent place in the economics curriculum.

THE LIMITS OF MONETARY POLICY The textbook answer to recessions is simple: When the economy suffers from high unemployment and reduced capacity utilization, the central bank can cut interest rates and stimulate the demand for goods and services. When businesses see higher demand, they hire more workers to meet it.

Only rarely in the past did students ask what would happen if the central bank cut interest rates all the way to zero and it still wasn't enough to get the economy going again. That is no surprise; after all, interest rates near zero weren't something that they, or even their parents, had ever experienced. But

now, with the Federal Reserve's target interest rate at zero to 0.25 percent, that question is much more pressing.

The Fed is acting with the conviction that it has other tools to put the economy back on track. These include buying a much broader range of financial assets than it typically includes in its portfolio. Students will need to know about these other tools of monetary policy — and will also need to know that economists are far from certain how well these tools work.

THE CHALLENGE OF FORECASTING It is fair to say that this crisis caught most economists flat-footed. In the eyes of some people, this forecasting failure is an indictment of the profession.

But that is the wrong interpretation. In one way, the current downturn is typical: Most economic slumps take us by surprise. Fluctuations in economic activity are largely unpredictable.

Yet this is no reason for embarrassment. Medical experts cannot forecast the emergence of diseases like swine flu and they can't even be certain what paths the diseases will then take. Some things are just hard to predict.

Likewise, students should understand that a good course in economics will not equip them with a crystal ball. Instead, it will allow them to assess the risks and to be ready for surprises.