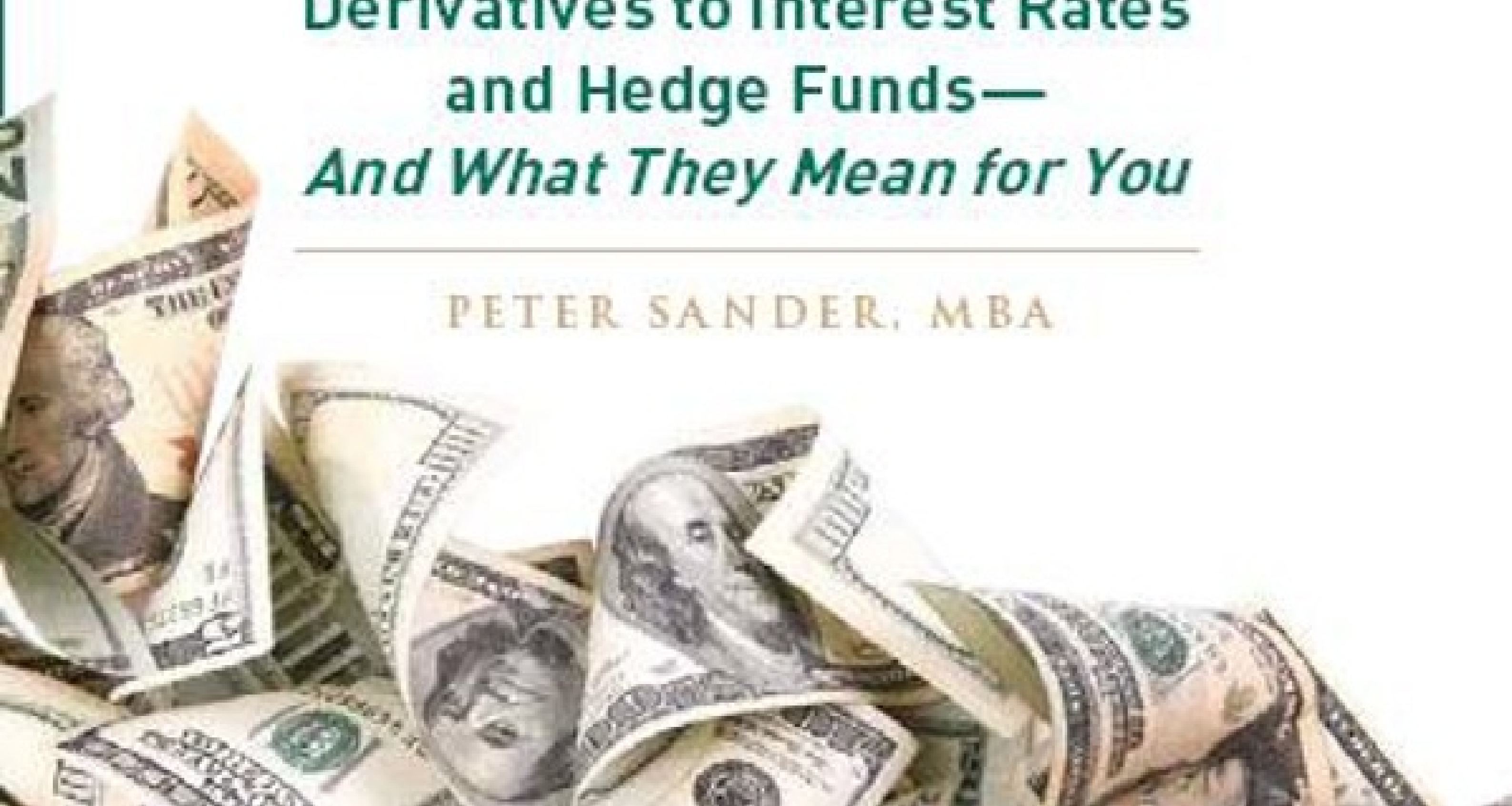
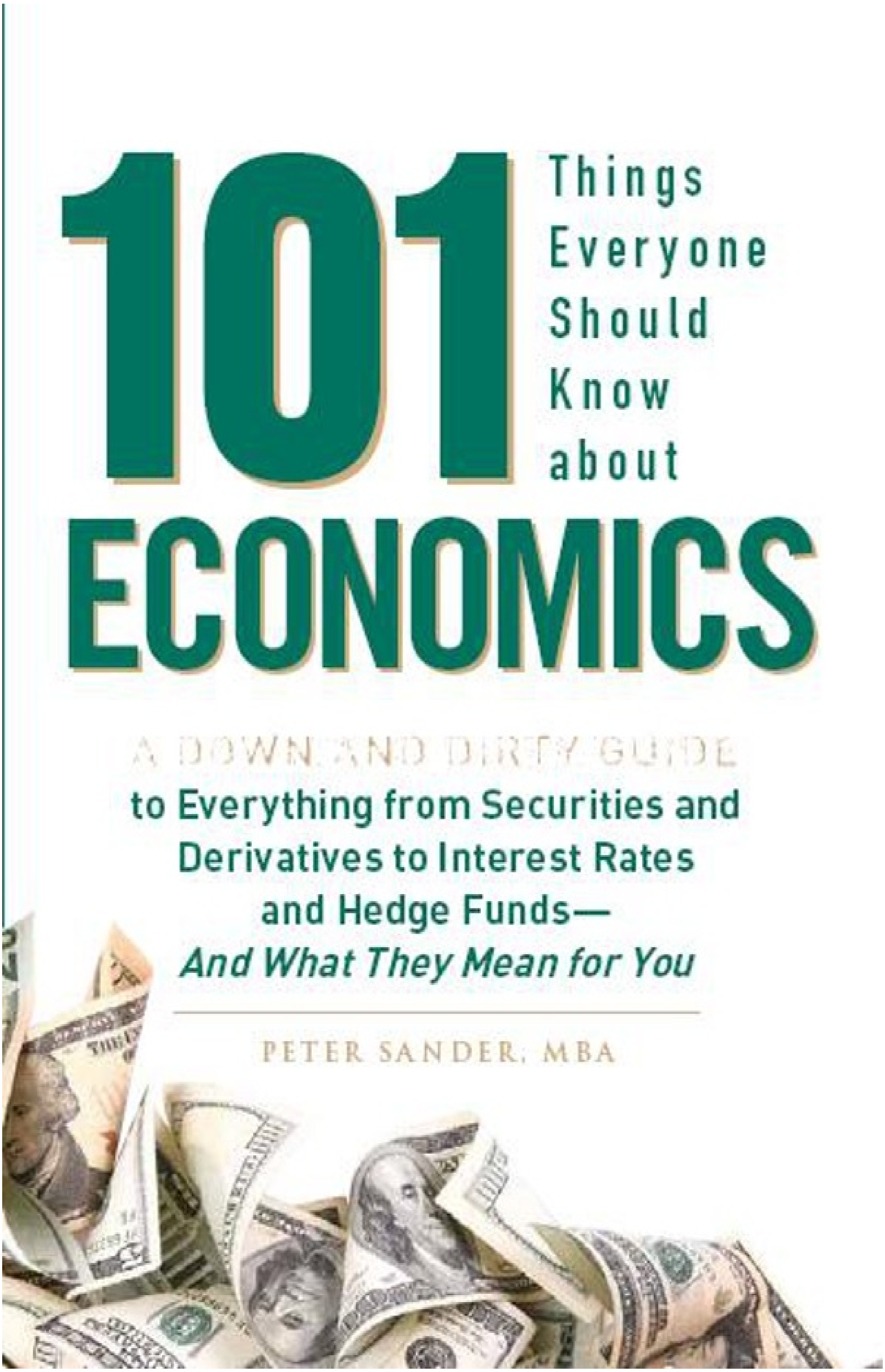
101 Things Everyone Should Know about ECONOMICS

A DOWN AND DIRTY GUIDE
to Everything from Securities and Derivatives to Interest Rates and Hedge Funds—
And What They Mean for You

PETER SANDER, MBA

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Contents

Introduction

What is the world coming to?

You read the headlines. Two appeared recently on the front page of the same newspaper (for those of you who still read newspapers):

Public Wary of Deficit, Economic Intervention
Historic Overhaul of Finance Rules

The *public* is wary of the deficit and economic intervention? I'm part of the public, so I guess I had better be wary, too. And a big change in the rules? Better keep up with that one, too. I earn, save, borrow, spend, and invest money, so I'd better find out about any changes in the rules.

Truth is, headlines like this have become part of daily life. Sure, a few years ago, headlines about GDP growth or trade deficits or interest rates were mostly background noise, to be ignored unless you were an economist. Things were going pretty well. We had money to spend, everything was growing just a little each year, our retirement accounts were growing steadily, our jobs were reasonably safe….

And then it happened.

It is the economic crisis. That big swoon of 2008–2009 after years of good times. Good times? Not for everyone, but for a lot of us. Our homes earned more than we did. We could borrow money cheaply and almost without any questions asked. We used our homes as ATMs. We could buy anything we wanted, and who cares about the debt, or deficits, or inflation? That was covered too, because home prices and other investment prices were going up. But it all went "poof" starting in 2007. The speeding locomotive of real estate prices, supported by lax lending, suddenly went into reverse.

And much to our surprise, everything turned out to be connected to everything else. The rest is history. And it's a history that will play out for years to come.

Some of you may have taken that boring senior-level econ class in high school. You may have a rudimentary understanding of economics from that or some other class or from an uncle or grandparent who got a kick out of telling you about the Great Depression. You may have learned something along the way about supply and demand. You understood the difference between macroeconomics and microeconomics. You know that a good economy means a strong GDP and low unemployment. You have an idea that when those things are going well, you're more likely to have some spending money in your wallet and that your 401(k) plans will grow at least a bit. You know enough to fear inflation and that someday there will be another recession, who knows when or why. But that's about it.

Now those relatively basic economic concepts have been set upon their ear. The news flashes are about "deleveraging," "deflation," "credit default swaps," "asset backed securities," "hedge funds" and "globalization." We have TARP and TALF and

Bear Stearns and Lehman Brothers. We have Timothy Geithner and Ben Bernanke and Bernard Madoff and a bunch of angry senators in the Senate Banking Committee. We have Barack Obama making almost daily pronouncements about the best way to fix the economy. We're becoming swept up in a horrifically complex, interconnected, and fast-paced world of change.

Worse, the powers that be at the Federal Reserve, SEC, and elsewhere for many years seemed to have control over things— if the economy went a little cool, they could stimulate it back to life; when it ran a little hot, they could cool it. They spoke of the "Goldilocks economy"—not too hot, not too cold. The medicine worked. And everyone *expected* it to work. However, in the past ten years and especially in the recent crisis the patient has become less responsive to the usual medicine. So what's the good doctor to do? Increase the dosage, naturally. That meant lower interest rates and greater financial stimulus for longer periods of time. Unfortunately, the "side effects"—the unintended consequences—include a real estate bubble, and many are worried today about catching a deadly inflationary virus as we move forward.

Bottom line: it seems like the more you know, the more you don't know, and since this stuff messes with your future, you'd better learn what's going on. So that's why *101 Things Everyone Should Know about Economics* comes to the table at just the right time.

This book is not a crash course on economics, although some may decide to use it that way. Most definitely it isn't a textbook. Instead, it is intended to provide a handy reference to the very real concepts and terms in use in today's economy. It connects things you read about and hear about to things you need to *know about* and *do.* Or *not* do. It's more than a study guide for your economic life. It is intended to help you understand how economic concepts affect *you*. It is intended to help you make sense of what is good for you and bad for you, both now and in the future. It is intended to help you ask the right questions and ultimately take the right actions.

By no means is this book, like so many other books and articles you read, designed to help you get rich or earn more money or even save money. And, very importantly, this guide is not meant to help you understand just *today's* economy and its opportunities and pitfalls. This book is meant to help you be more knowledgeable, more aware, and more *prepared* going forward. Prepared to recognize the next crisis. Prepared to deal with it. Prepared to come out better than you did the last time. Prepared to come out better than you otherwise would have.

And that preparation is important. Today's schools turn out graduates at all levels prepared to handle a career, perhaps multiple careers. But they still don't—much to our detriment—offer preparation for economic life. Even the "home economics" courses of the 1950s are gone—there is virtually nothing to help you live prudently or efficiently or economically, save for the vast assortment of books and magazines that tell you where to put your money *this* year. I believe a more basic understanding is necessary before you can trust yourself to make the right decisions. Today's education and media leave a huge gap in that area. *101 Things Everyone Should Know about Economics* is the fastest, friendliest and most effective way to fill the gap.

THE ECONOMY IN SEVEN STEPS

Whether it's a book or a business presentation, I believe any complex topic can be broken down into between three and seven important pieces. That principle applies here. The first chapter acts a refresher to common economic terms and then the remaining seven discuss the 101 economic concepts. I describe the concept, fast facts, what you should know and why you should care about it. Common sense, start to finish.

- *Chapter 2: Economy and Economic Cycles.* A look at the economy as a whole as well as its current condition. This chapter offers a little bit of history with special focus on the ups and downs, the booms and busts, why they happen, and how they affect you.
- *Chapter 3: Money, Prices, and Interest Rates.* What money is, what it does, and what happens to it, including inflation, deflation and stagflation, and the cost of money—interest rates and the dynamics around them.
- *Chapter 4: Banks and Central Banking*. Once we understand money, it's time to learn about banks—the different kinds of banks and how the banking system works, with special emphasis on the Federal Reserve and its relationship to the banks and the economy at large.
- *Chapter 5: Governments and Government Programs*. With the basic system outlined, who are the big government players in the economy and what do they do? What are the most important laws and policies, why are they there, and how do they affect us?
- *Chapter 6: Economic Schools and Tools*. From government and government policy, we take another step toward the "big picture." What are the major schools of thought for managing or guiding the economy? How do they work? How do they explain what has happened, what should happen, or what's going to happen with our economy?
- *Chapter 7: Finance and Financial Markets*. The first six chapters covered the "macro" world. But what about all those things that happened on Wall Street that got us into trouble? Yes, there are hundreds of books about the stock market and Wall Street. But do they explain how Wall Street concepts connect to the larger economy? Do they explain "collateralized debt obligations" in plain English?. And what do you need to know about the financial markets and "retail" financial people like broker-dealers and financial advisers? And what about all those terms you see daily about real estate? Is a stock market short sale the same as a real estate short sale?. This chapter explains the most important financial markets and instruments of today.
- *Chapter 8: Trade and International Economics*. What is globalization, and how will it affect you? What makes the dollar gain against the euro, or vice versa? And what about those trade deficits? How does (and should) foreign trade work in a "new" economy? And how will that affect your job, the cost of living, and your life?

In the nineteenth century, the historian Thomas Carlyle was the first to refer to economics as “the dismal science.” (To be fair, Carlyle wasn’t exactly a bundle of laughs himself.) Since then, economics has labored under the burden of descriptions like “boring,” “complicated,” and “dry.”

It doesn’t have to be that way, and I hope this book will convince you otherwise. Economics is about the most basic human activities: what we produce, how we produce it, and how we consume it. It’s concerned, in other words, with human behavior— in fact, in recent years the field of behavioral economics has risen to prominence because of bestselling books like *Freakonomics*, *The Black Swan*, and *Predictably Irrational*.

In this book, we’re interested in what different economic terms and concepts mean and how they affect us. So, to rather freely adapt a phrase made popular in the movies: read on and prosper.

CHAPTER 1

The Basics

If you have taken an introductory economics course in high school or college or have read a basic economics textbook, you can probably skip this chapter and go right to the next. But if you want to refresh your grasp of basic economic terms, read on. You can also use this resource as you go through the book.

A GLOSSARY OF BASIC ECONOMIC TERMS

Asset. A property; something that is owned. For businesses, it can take the form of tangible physical items such as factories, products, and equipment or tangible financial items such as cash or receivables, that is, money owed to the firm. Assets can also be intangibles such as patents, trademarks, and copyrights. Such assets often fall into the category of *intellectual property*, a concept that's the subject of a growing body of law. In the age of the Internet and with complex financial transactions, determining the value of an intangible asset has grown very complicated and is likely going to become more so in the future.

Broker. Someone who sells or buys things on behalf of other people for a fee, or *commission*. For example, a mortgage broker arranges and sells mortgages. An insurance broker arranges the sale of insurance policies to clients, and so on. The term *brokerage firm* usually refers to a company that deals in stocks. In addition, brokers often make recommendations to their clients about what to buy and sell, but in most cases the buy or sell decision rests with the client.

Capital. In economic terms, capital is one of three factors involved in the production of goods or services (the others are land and labor). Capital can include goods or physical assets like factories or equipment, or financial assets like cash or other monetary resources used to run a business or public agency.

Competitive Advantage. It's the nature of capitalism that businesses compete against one another. Each entity tries to find some special way of beating its rivals, something that makes it stand out among the competition. That something is competitive advantage (also sometimes called the *comparative advantage*). Such an advantage can be based on product (quality or technical leadership, for example), price, distribution, or service, among other things. Competitive advantage is one of the most valuable tools a company has to ensure its growth, and companies try to protect their competitive advantages from all rivals.

Consumer. Anyone who purchases and uses goods and services that companies produce. Consumers have become a major driving force in the United States economy, and companies compete fiercely for their business. To this end, they spend a lot of time analyzing consumers, trying to figure out their buying patterns, behaviors, and so on.

Credit. Money that's loaned, or potentially loaned to an individual, business, or public entity. For an individual, credit can be in the form of a mortgage, a car loan, a line of credit through a credit card, or any one of numerous other forms. For a business, credit also comes in the form of a loan or a line of potential credit, or for a larger business, in selling securities, namely, bonds or other debt instruments. When you have credit, that's money that has been loaned to you by someone else. If you're a *creditor,* you've loaned money to someone, and they'll have to pay it back to you, usually with interest.

Debt. Something you owe to someone else. Personal debt has become a huge issue in the United States in recent years, and many people, as a result of their exploding debt, have suffered bankruptcies and foreclosures. However, some debt can be good—for example, if it's used to buy something that will provide greater value over time (like a personal residence), or something that you need but will cost more in the future. When you purchase something you don't need or can't afford or is "used up" before the debt is paid off, that's considered "bad" debt.

Economic Forecast. An estimate of where the economy, a business, or some component of it is going. Different government agencies, as well as private and quasi-public agencies, make economic forecasts, some of which can affect the performance of the markets. Businesses use forecasts to plan their goals and budgets.

Elasticity. In economics, the tendency for demand to rise or fall for an item when the price rises or falls. In a more technical sense, it's the ratio between the percentage change in two variables (for example, supply and price). For instance, if the price of a product rises slightly and immediately the demand for it falls dramatically, the product is said to have high elasticity. The price of a product such as gasoline, on the other hand, can rise quite a lot before demand drops substantially, so it's said to have low elasticity.

Entrepreneur. Someone who starts a business and takes responsibility for its success or failure. The term has also come to mean someone who shows enterprise, initiative, and daring as an employee or in the business community at large. Small businesses, started and operated by entrepreneurs, represent 99 percent of all U.S. businesses, and for many they represent American capitalism in its purest form.

Free Enterprise. An economic system in which markets and companies are privately owned and are free to compete against one another with minimal government restrictions. This is the system that exists in the United States. It's sometimes referred to as *laissez-faire capitalism* or *free-market capitalism*.

Interest. The fee paid in order to use money borrowed from someone else. Essentially, this is the cost of obtaining credit.

Interest is calculated as a percentage of the amount borrowed. This percentage is called the *interest rate*. You'll hear about *simple interest,* which is interest paid or received over a single period, such as a year, and *compound interest,* which is interest received over a number of periods and reinvested so that additional interest is received on interest already received earlier. See #21 Interest Rates.

Investor. Someone who puts money into a business to produce a *return*, that is, to make money on their money. Sometimes investors do this by loaning money to the entrepreneurs who are starting or running the business, or by buying an interest (sometimes, stock) in their business. The money they receive, either as payments or from a sale of the investment down the road, is called the *return on investment*, and is calculated as a percentage based on the returns divided by the amount of the investment.

Macroeconomics. As implied by the prefix "macro," the study of economics in the big picture, that is, regional, national, or international economic activity, trends, and issues. Macroeconomists try to figure out what drives entire economic systems and what impact these systems, or components of the systems, have on each other.

Microeconomics. The opposite of *macroeconomics*, microeconomics studies economic movement for individuals, businesses, or other entities within the economy, including the dynamics of pricing, supply and demand for individual goods and services. Microeconomists also study the behavior of companies and regions to understand how these units are allocating their resources and responding to pressures from above and below.

Monopoly. A single company or individual controlling an entire product or service. Monopolies can charge excessive prices and reap excess profits because of their controlling position in a market. In the nineteenth centuries, monopolies were fairly common in America (Standard Oil, for example). Throughout the late nineteenth and twentieth century, many of them were broken up by legislation, starting with the Sherman Anti-Trust Act of 1890. Today, government agencies review mergers in an attempt to prevent the formation of monopolies. In recent years, several companies, notably Microsoft, have faced monopoly criticisms and actions.

Mortgage. A loan made based on security, especially real property, pledged to ensure its repayment. When you take out a mortgage, you borrow money and give the lender a *lien* on a property as *collateral* to secure the repayment of the debt. When you've paid off the mortgage, the lien will be cancelled. If you don't repay the debt, the lender can *foreclose* on the property, that is, take legal possession of it.

Outsourcing. The increasingly common practice of contracting people outside an organization to perform work that used to be done by workers within a company. Outsourcing has grown massively to include everything from call centers and customer service to information technology services. Many American companies are outsourcing, or *offshoring*, overseas to countries such as India and China, where labor costs are less.

Productivity. A measure of efficiency. It's often expressed as the ratio of units to labor hours (a company produces 2,000 pairs of shoes per hour, for example). Productivity is one element that's factored into studies of *economic growth*. In general, industries try to increase productivity through technological innovation and other methods.

Profit Margin. A measure of a company's profit performance that may occur at several levels. For example, *gross margin* is a company's revenue less the direct costs of producing a good or service but before expenses. *Operating margin* is revenue less costs and expenses; *net margin*, or *net profit*, is revenue less costs, expenses, and taxes. These figures are commonly represented as percentages, and are key indicators of a company’s health.

Publicly Held Company. A company that’s registered with the Securities and Exchange Commission and whose stock is traded on the open market where it can be bought and sold by the public. In a *privately held company*, on the other hand, stock is held by a relatively small number of shareholders who don’t trade it openly. Often these are family or friends of the owner. Eventually, the company may “go public,” holding an *initial public offering* and selling shares on the open market.

Return on Investment. A measure of how much money an investor gets back relative to the amount invested. It’s sometimes called the *rate of return* or *return rate*. Many people make decisions about investments based on a calculation of ROI.

Venture Capital. Money, or capital, invested directly into new businesses by outside investors. Venture capital investors tend to look for high-potential start-up companies that can grow quickly and provide a strong return on investment. *Venture capitalists* may be investors themselves or may invest on behalf of other investors. Family and friends who lend money for start-ups are sometimes referred to as *angel investors.* In some cases, venture capitalists anticipate that the company will grow to a certain size and then be sold for a profit, producing a rich return. Alternately, the company may take itself public, selling shares in an *initial public offering (IPO)* as has happened with Google and many other technology firms. See #73, Private Equity.

CHAPTER 2

Economy and Economic Cycles

We start with the economy. Not a big surprise in a book titled *101 Things Everyone Should Know about Economics.* By way of definition, the economy is a system to allocate scarce resources to provide the things we need. The economy consists of the production, distribution, consumption, and exchange of goods and services. It is about what we do as a society to support ourselves, and about how we exchange what we do to take advantage of our skills, land, labor, and capital.

Of course, that definition is a bit oversimplified. The economy is really a fabulously complicated mechanism that hums along at high speed—lightning speed with today's technology—to facilitate production and consumption. The economy itself is fairly abstract, but touches us as individuals with things like income, consumption, savings, investments, or more concretely, with money, food, cars, fuels, and savings for college.

One could only wish ours was a "steady state" economy, that it would always provide exactly what we need when we needed it. Unfortunately, it isn't so simple. The economy is directly influenced by a huge, disconnected aggregation of individual decisions. There is no "central" planning for the economy (yes, it's been tried but doesn't work for a variety of reasons), although governments, central banks, and other economic authorities can influence its direction. Because the economy functions on millions of small decisions, the economy is subject to error—overproduction and overconsumption for example. Take these errors, add in a few unforeseen events, and the result is that economies go through cycles of strength and weakness.

The first fifteen entries describe the economy, economic cycles, economic results, and some of the measures economists use to measure economic activity.

1. INCOME

Income is the money we receive in order to buy what we need when we need it. Economists look at income in several different ways—including where it comes from, how much is earned, and how much of what is earned can really be spent. Income includes the following money flows: wages to labor, profit to businesses and enterprise, interest to capital, and rent to land.

What You Should Know

Income is what people earn through either direct labor or as owners of investments.

The amount of income we earn as individuals and families connects to the economy's prosperity and strength. It dictates how much we can ultimately spend and the value we bring to the economy as a whole. The amount of income earned collectively as a country determines the economic health of a nation and of groups within it.

Economists look at *national income* (covered further under #4 Gross Domestic Product), *per capita income* (income generated per person), and *household income* (how much income is generated by the average household). In all but the worst times, incomes should rise as people accomplish more by becoming more skilled and productive at their jobs and in their businesses. Economists also speak of *real* income increases—that is, increases adjusted for inflation, as opposed to *nominal* increases, which represent the raw numbers but not necessarily true income growth.

Economists also consider *disposable income*, or the amount of income actually available for individuals and families to spend after taxes. Disposable income is a truer indicator of how much purchasing power we really have, and how much of that purchasing power will ultimately be available to drive the economy and create more income.

Income figures are published in the financial press and can be seen in greater detail on the U.S. Census Bureau's website: *www.census.gov/hhes/www/income/incomestats.html*. The Census Bureau measures income annually through the American Community Survey. The annual press release will contain statements like: "Real median household income in the United States climbed 1.3 percent between 2006 and 2007, reaching $50,233."

Why You Should Care

Most of you probably care more about your personal income than that of the nation or others around you! Your own income ultimately determines your purchasing power and is a key factor in your overall quality of life. If your income isn't increasing—or worse, if it is decreasing—you know that's not a good thing, and you might have to adjust your way of life.

Watching published income figures helps you keep tabs on the ups and downs of the economy. By itself that may or may not interest you depending on your profession or general level of interest in national success. However, if you track national, household, and per capita income *changes* and compare them with your own, you can see whether you're gaining or losing ground.

Income changes can also be useful as a measuring stick for other economic factors, like growth in asset prices. During the recent real estate boom, for example, home prices far outpaced gains in income. Smart economists knew this couldn't last forever. Either incomes had to rise (to keep pace) or home prices had to stabilize or fall (to allow incomes to catch up). So watching gains in income can be a good test to make sure other economic changes make sense.

See also: #2 Consumption, #4 Gross Domestic Product (GDP), #14 Distribution of Income and Wealth

2. CONSUMPTION

Consumption is what we consume. And like income, the measurement of consumption at a national level helps us understand whether the economy is getting weaker or stronger. As an individual, you have more control over consumption than income, so it's important to monitor your consumption to be certain you can make ends meet.

What You Should Know

Economists track *personal consumption expenditures (PCE)*. As the term implies, PCE represents funds spent on goods and services for individual consumption. "Goods" breaks down into *durable* goods—goods expected to have a useful life greater than three years, like cars and lawnmowers—and *nondurable* goods like food, paper products, cleaning supplies, and so forth. Personal consumption expenditures exist in addition to private business investment, providing goods and services for export, and government consumption of goods and services.

The Bureau of Economic Analysis (*www.bea.gov*) monitors and publishes PCE reports; the Bureau of Labor Statistics (*www .bls.gov*) gives longer histories and projections for PCE. For example, BLS projects PCE to return to a 2.9 percent average rate of growth from 2006 to 2016 after enjoying a ten-year period of higher growth at 3.7 percent. Since consumption accounts for some 70 percent of the total economy, the difference is a big change and a sign of lower prosperity ahead. The fact that consumption growth has exceeded income growth until very recently has resulted in the massive buildup of consumer debt.

Before the 2008–2009 downturn, PCE growth had been quite steady; when the downturn began, many individuals lost jobs or panicked (for good reason) and tightened their belts. Monthly PCE readings, as a result, have become much more volatile. That volatility doesn't help economists forecast the future, nor does it help the guy or gal running the corner store.

Why You Should Care

At a national level, low interest rates, easy credit, and low-cost imported goods have combined to cause a consumption bubble of massive proportions; the 2008–2009 downturn is in part an unwinding of that bubble. Savings rates (covered in the next entry) have gone from negative to moderately positive as consumers have become more conservative. This caution has brought consumption back to more sustainable levels, that is, somewhat less than income and more in line with income growth.

That's a good thing on a national basis. The key for you as an individual is to make sure your own PCE is in line with your income and income growth. And if you're an investor, monthly PCE reports can give you an insight to where the economy is headed.