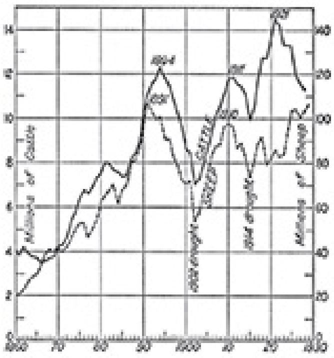

ECONOMICS IS THE STUDY OF HOW INDIVIDUALS, INSTITUTIONS, AND SOCIETY CHOOSE TO DEAL WITH THE CONDITION OF SCARCITY

LONG-TERM TREASURY SECURITIES ARE REFERRED TO AS TREASURY BONDS OR T-BONDS

ECONOMICS 101

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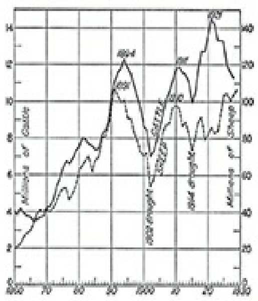
A CRASH COURSE IN **MONEY** *and* **FINANCE**

EXAMPLES OF VARIABLE COSTS INCLUDE HOURLY WAGES, RAW MATERIALS, UTILITIES, AND PER UNIT TAXES

ALFRED MILL



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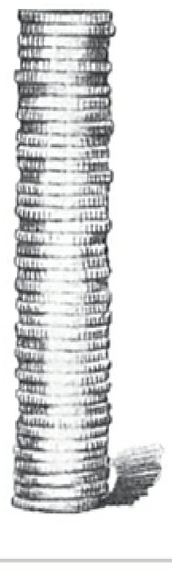

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INTRODUCTION
WHY UNDERSTANDING ECONOMICS MATTERS

Do you have preconceived ideas about economics? Do you want to know how the economy works, but find yourself nodding off? Do you want to learn more but are turned off by the dry, technical language and "all this talk about money"?

In *Economics 101*, you'll realize that economics doesn't have to boring. In fact, exploring this subject will make you look at the world in ways that you would have never considered before. Economics lets you make connections between seemingly disparate things like the rate of unemployment and dear old Dad's tendency to replace his underwear. And you'll understand the world better. When interest rates change, you'll be able to predict the ramifications. A meaningful discussion of stocks, bonds, mutual funds, and collateralized debt obligations will no longer sound like some strange dialect of Portuguese. While this is not a personal finance book, the principles of economics it describes will help you keep your own financial house in order.

In economics, expectations become reality and money is just a social construct. That's not boring, that's mind-blowing! After reading *Economics 101*, you'll come to know and love concepts like diminishing marginal utility, and everyone's new favorite, quantitative easing. Wrapping your mind around these ideas will help you make better sense of the economy around you and why people behave as they do in money matters (hint: it's not always rationally!). You can even put the information to use by teaching your boss about controlling variable costs and maximizing profits. Exchange rates and savings flows will be like child's play for you, capital and investment will take on a whole new meaning, and constructing a CPI and deflating nominal GDP will be second nature to you. Your poet hippie cousin that lives in a van and plays guitar will be thrilled when you explain to him why he is technically not unemployed.

Economics isn't just about defining abstract terms like some of those I've mentioned. It's actually an exercise in philosophy! By that I mean economics impacts every aspect of your life and influences everything that you do. And I mean everything! Economics teaches that nothing is free. Costs are involved with every choice, even if the choice doesn't seem to have any bearing on money matters at all.

Economics isn't something done by nameless groups somewhere far from home. All economic decisions are made by individuals. Individuals bear the cost of these decisions. Yes, that means you. Economics is personal. *They* do not set prices. *We* set prices.

After reading *Economics 101*, you'll know why the world works as it does. Here, you'll learn such things as:

- Why you can have too much of a good thing. (Utility is diminishing).
- Why unemployment by any other name is probably not unemployment.
- Why what is true in the long run might not be true in the short run.
- Why policymakers who manage expectations can manage reality.

- Why, if given a choice between inflation and deflation, you should choose inflation.
- Why individuals are better at managing their finances than are governments.

Ready to start exploring the mind-expanding world of economics? Let’s go!

WHAT IS ECONOMICS?

Taking the Dismal Out of "the Dismal Science"

You open the door to your fridge and gaze at the food inside and declare, "There's nothing to eat in this house." Later, you walk into a closet full of clothes and then think, "I have nothing to wear." You are faced with scarcity. You never have enough of what you need or want. The fact is, you have plenty to eat and many clothes to wear. You chose to ignore the options you faced then and there, but eventually you know you will relent and eat the apple next to the shriveled grapes at the bottom of the bin, and then put on the shirt and pants you hate. You are a creature of economics. Given scarcity, you look at the choices you face, evaluate, and then choose.

STUDYING SCARCITY

Economics is the study of how individuals, institutions, and society choose to deal with the condition of scarcity. It is fascinating to see how people react to scarcity. Some create complex plans and systems to make sure that everyone gets their fair share of scarce resources. Others make things up as they go along. Everybody practices economics on a daily basis. From a single individual to the largest society on earth, people are constantly engaged in the struggle to survive, make ends meet, and even thrive given the relative scarcity they face.

The Child of Philosophy

> Economics has been around a long time, though it has not always been known by that name. Philosophers studied scarcity and choice long before the field was so named. The father of modern economics, Adam Smith, was considered a moral philosopher, not an economist.

The people who study these choices are economists. The field of economics is huge because people have an immense range of choices. Some economists study the decision-making of individuals and institutions; others study how nations handle scarcity. Economists develop theories to explain the behavior of whatever it is they are studying. Some of these theories are then tested against real-world data, and sometimes these theories are put into practice without ever being tested. Economists work for universities, financial institutions, major corporations, and governments.

MICROECONOMICS

The field of microeconomics focuses its attention on the decision-making of individuals and businesses. Microeconomics is primarily concerned with markets for goods, services, and resources. Markets are central to understanding microeconomics. Whenever and wherever buyers and sellers come together to exchange resources, goods, or services, a market is created and the behavior of these markets is of particular interest to economists. Are they functioning efficiently? Do participants have access to adequate information? Who and how many participate in the market? How do the decisions made in one market impact the decisions in a related market?

MACROECONOMICS

Macroeconomics is the study of how entire nations deal with scarcity. Macroeconomists analyze the systems nations create or allow for the allocation of goods and services. The questions they ask are varied and of great interest to individuals and policymakers alike:

- How do you measure the economy?
- Why does unemployment exist?
- How do changes in the amount of money affect the entire economy?
- What impact does government spending or tax policy have on the economy?
- How can you make the economy grow?

SCARCITY

Without scarcity there would be no need for the study of economics. For that matter, if scarcity did not exist, there would be no need for this book. You’re not that lucky, however. Scarcity is the universal condition that exists because there is not enough time, money, or stuff to satisfy everyone’s needs or wants. The stuff that everyone wants is made from resources. In an effort to make economics sound more “economic-y,” resources are referred to as the factors of production. The factors of production include land, labor, capital, and entrepreneurship.

Is There Really Scarcity in America, a Land of Plenty?

Scarcity exists for everyone. From rich to poor, all face the condition. Scarcity in America looks different from scarcity in Somalia to be sure. Here, there is plenty of food and clean water, but in Somalia both are lacking. Scarcity isn't just a function of limited resources, but also of unlimited wants, and that is something both America and Somalia share.

- Land is inclusive of all natural resources and not just some random piece of property. Trees, mineral deposits, fish in the ocean, ground water, and plain old land are all included. Land can be divided into renewable and nonrenewable natural resources. Renewable resources, like pine trees and chickens, are easily replenished. Nonrenewable resources, like oil and Atlantic cod, are difficult to replenish. The payment for land is referred to as rent.
- Labor refers to people with their skills and abilities. Labor is divided into unskilled, skilled, and professional. Unskilled labor refers to people without formal training who are paid wages to do repetitive tasks like make hamburgers or perform assembly-line production. Skilled labor refers to people paid wages for what they know and what they can do. Welders, electricians, plumbers, mechanics, and carpenters are examples of skilled laborers. Professional laborers are paid wages for what they know. Doctors, lawyers, engineers, scientists, and even teachers are included in this category.
- Capital in economics does not refer to money, but to all of the tools, factories, and equipment used in the production process. Capital is the product of investment. Stop. Isn't that confusing? Up until now you have probably lived a happy life thinking that

capital was money and that investing is what you do in the stock market. Well, sorry. Capital is physical stuff used to make other stuff, and investment is the money spent on buying that stuff. To make capital, you have to have capital. Because capital is always purchased with borrowed money, it incurs an interest payment.

Money Talks

allocation

Economists describe getting the right resources to the right people as allocation. Allocative efficiency occurs when marginal benefit equals marginal cost. When this condition is met, the greatest benefit accrues to society.

TRADE-OFFS AND OPPORTUNITY COST

Making an Assumption Out of You and Me

Whenever you use a factor of production, a cost is going to be incurred. Why? The factors of production are limited, not limitless. As a result, whenever you choose to use land, labor, capital, or entrepreneurship for one purpose, you lose the ability to use it for another. Take a resource like labor—your labor. Say that you can spend an hour writing a book, teaching a class, or weaving a hammock. The choices you face are called trade-offs. Assume you choose to weave a hammock. You can neither teach a class nor write a book in that hour of time. If writing a book is your next best alternative, then economists would say that the opportunity cost of spending an hour weaving a hammock is the hour you could have spent writing a book. Opportunity cost is the next best alternative use of a resource.

Implicit and Explicit Costs

Opportunity cost is sometimes referred to as implicit cost. For any productive activity there are explicit costs like labor, raw materials, and overhead, which are easily calculated, and there are the implicit costs, which are more difficult to assess.

CONSIDERING OPPORTUNITY COST

For example, suppose it's a beautiful Friday morning and you think to yourself, "I could go to work like I'm supposed to, I could stay home and sleep away the day, or I could fly to Cozumel and hang out on the beach and do some scuba diving." Assume that you chose to take the trip to Cozumel, but going to work was your next best alternative. What was the cost of your trip? You paid for the taxi to the airport, the plane ticket, an all-inclusive hotel package, and a dive on Palancar Reef. Was that your only cost? No. You also sacrificed the money you could have made working. Opportunity cost is a bummer. Make sure to always count it when making a decision.

MARGINAL ANALYSIS

Economists like to think of people as little computers who always count the benefit of their decisions versus the cost of those decisions. Because you usually make decisions one at a time, economists refer to the benefit of a decision as marginal benefit. Marginal benefit can be measured in dollars or utils, whichever you prefer. Utils are the amount of utility or happiness you get from doing something. They can be converted into dollars easily.

Say that you like to swim laps in the pool for an hour. How many utils do you receive from swimming laps? How much would you have to be paid to not swim laps? If your friend were to keep offering you ever-increasing amounts of money to not swim in the pool, then it is probably safe to assume that the dollar amount you accept to not swim in the pool is at least equal to the amount of happiness or utility you would have received had you taken a swim.

If it takes $20 to keep you from swimming, then you value swimming no more than $20. Swimming is worth 20 utils to you.

Marginal cost is a related concept. Marginal cost is simply what it costs to either produce or consume one extra unit of whatever it is you are producing or consuming. Go back to the swimming example. Assume that swimming in the pool has a marginal cost of $5. If you earn 20 utils from swimming, would you pay $5 to earn $20 worth of benefit? Of course you would. Now assume that swimming in the pool costs $20.01. Would you spend $20.01 to earn $20 worth of benefit? Probably not. Economists conclude that you will swim as long as the marginal benefit exceeds or equals the marginal cost. For you that means you will swim as long as the marginal cost is less than or equal to $20. If the marginal benefit outweighs the marginal cost, you would probably do it. If the marginal benefit is less than the marginal cost, you probably would not do it. If the marginal benefit equals the marginal cost, it means you are indifferent.

ASSUMPTIONS IN ECONOMICS

Economists make certain assumptions when they're talking about their favorite subject. They expect you to know (and agree with) these assumptions. The three big ones are:

1. Nothing else changes. Whenever economists make an argument such as: "If income taxes fall, then consumption increases," it should be understood as: "If income taxes fall *and nothing else changes*, then consumption increases." Did you catch the difference between the two statements? *And nothing else changes* is also referred to as the ceteris paribus assumption. Loosely translated, ceteris paribus means "to

hold all other things constant." So as you continue reading the book, remember that all statements about cause-and-effect relationships are made with the ceteris paribus assumption.

2. People are rational and behave rationally. Another assumption made by economists, and a big one at that, is that people behave rationally. Economists assume that people's choices are made with all available information taken into account as well as the costs and benefits of the choice. Furthermore, economists assume that the choices make sense. The assumption that people behave rationally is subject to debate among different schools of economic thought, but for most economic decisions it is a useful assumption.
3. People are selfish. The last assumption made by economists is that people are self-interested. First and foremost, people think of themselves whenever it comes time to make a decision. Pure altruism is not possible in economics. Economists cynically assume that human behavior is motivated by self-interest. For example, a grenade is thrown into a trench with a platoon of soldiers and one soldier sacrifices his life by jumping on top of the grenade, thus saving the others. To economists, this soldier instantly calculated the marginal benefit and marginal cost of the decision, determined that the marginal benefit of saving his fellow soldiers outweighed the marginal cost of his life, and jumped on the grenade as an act of utility, maximizing self-interest. He saved his friends in order to maximize *his* utility as a soldier.

The assumptions economists make are subject to criticism and debate. Many critics believe that the field has a tendency to be too abstract and theoretical to have any real-world value. The failure of most economists to predict the most recent economic downturn seems to support the view that economics ignores human psychology at its own peril.

Economics is at a turning point as a field of study, and the assumptions that economists hold dear need to be carefully examined. Instead of being tidy, abstract, and mathematical like physics, economics must become a little more messy, complex, and organic, like biology.

Money Talks

consumption
Household spending on new domestic goods and services.