PRACTICAL ECONOMICS

Monica Haven, E.A. will explore the history of capitalism, compare and contrast various economic theories, and teach you to apply these lessons to the practical aspects of personal financial management.

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

I. History of Capitalism

A. Feudalism

- A contractual system of political and military relationships designed to preserve medieval Europe from disintegrating into a myriad of political factions
  → Land and labor (fiefs) were exchanged for an oath of homage and fidelity
  → Relationships were often hereditary and could only be severed by force
- 13th century: fiefs began to make monetary payments rather than pledge military service
- Slavery (serfdom) was introduced in Europe during Middle Ages but officially abolished in Denmark in 1792 (1808 in the United States)

B. Mercantilism

- Distribution of goods for profit as they are moved from one geographic location to another
  → Focus was on the exchange, rather than the production of goods

- Ownership interests of the state (sovereign) were superior to those of individuals—national pre-occupation with the accumulation of wealth (exports favored over imports)
  → Originated with the expansion of the Roman Empire but disappeared by 700 A.D.
  → Renewed expansion as Islam spread across northern Africa, southern Europe, and Asia
  → By 1300's, Europeans adopted mercantilism

C. Early Capitalism

1. François Quesnay—*Tableau économique* (1758)
   a. Society's classes
      - Productive Class: ~ ½ of population engaged in agriculture, fishing, mining
      - Proprietary Class: ~ ¼ of population who owned land
      - Artisan (or Sterile) Class: Remaining ¼ of population
   b. Only Productive Class capable of producing a surplus which could be taxed to support the state, since manufacturing was regarded simply as a way of recycling the output already generated by the Productive Class
   c. Physiocracy = wealth of nations derives only from agriculture

2. Adam Smith—*An Inquiry into the Nature and Causes of the Wealth of Nations* (1776)
   - Natural economic order included similar physiocratic classes, but did not preclude the Industrial Class from generating a potential surplus
   - The desire to achieve and to better oneself is a positive impulse, contrary to religious teachings of the time (avarice or greed was considered a sin) ➔ Self-interest was not selfish, but motivated people to exert extra effort

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- Business owners got richer, expanded their businesses, hired more people who in turn also got richer and formed their own businesses ➔ Wealth creates opportunity
- The laws of supply and demand are regulated by an invisible hand ➔ There is no need for government intervention

3. Industrial Revolution
   - Human and animal power was replaced by mechanical power, production was centralized into factories, artisans were relegated to the periphery of society
     → Working Class emerged
     → Standard of living rose slowly but steadily
   - Entrepreneur = Risk-taker willing to absorb a potential loss in the event of an unfavorable and unpredictable outcome

D. Modern Capitalism—basic tenets:
- Private Ownership: Material, land and tools are accumulated by only a few individuals for the production of goods and services
- Self-worth: Labor is compensated monetarily, rather than exchanged for product
- Rational Self-interest: The individual, not the State, must be free to pursue his own interests
- Market System: Social relationships between producers and consumers are severed
- Economic Growth: The accumulation of wealth is paramount
- Consumer Sovereignty: Consumers shall seek greatest self-satisfaction
- Primary Motivations: Competition and profit
- Government Intervention: Laws are created to curb abuses where self-regulation fails
  → Guilds (a.k.a. hansas or fraternities)—associations formed to protect traveling merchants formed during the 11th century
  → Led to monopolization due to favored treatment of members who could sell at retail prices while all others were forced to charge wholesale
  → Replaced by craft guilds in 14th century which divided their memberships into three classes: Masters (owners of the raw materials and tools who would profit from the production of goods), apprentices (lived in the home of the master and learned the trade receiving board in exchange for labor provided) and journeymen (received fixed wages for their labor)
  → Journeymen guilds became the precursors the modern trade unions, which declined in power when capitalism stressed competition

E. Alternative Economic Practices

1. Socialism (a.k.a. Collectivism)
   - Collective or government ownership and management of the means of production, natural resources, basic industries, banking, and public utilities (some less vital enterprises may be held as private cooperatives)
   - Dependent upon cooperation and social service without the recognition of any classes

2. Communism
   - Based on the teachings of Karl Marx—*Das Kapital* (1867-94)
   - All means of production are owned by a single authoritarian party which controls both the economic and political systems—no private property of any sort is tolerated
   - Products are distributed according to need, not wealth

3. Communalism
   - Means of production are owned by a smaller unit (a commune)
   - The state has reduced authority

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II. Parallel History of the Stock Market

- **1500's** King of England grants Sir Thomas Smythe right to be 1st governor of East India Co., specializing in trade of silver, gold and commodities for barter (**= Mercantilism**)
- **1602** Amsterdam Exchange is formed to trade shares of East India Co.
- **1609** A Dutch trading post is founded on the Hudson River and a wall of mud and brush is erected to protect the village from marauding Indians
- **1626** Dutchman Peter Minuit trades $24 worth of beads Indians for Manhattan Island (land worth ca. $17 trillion in 1987 vs. $32 Trillion if allowed to compound at 6% annual return)
- **1751** Brokers gather under a tile roof in Lower Manhattan to form The Royal Exchange and trade wheat, tobacco, cotton, sugar and slaves
- **1764** Currency Act—British ban the use of paper money in the Colonies
- **1780** Bank of Pennsylvania is established
- **1787** U.S. Constitution is ratified and Congress is given the power to coin money
- **1790** Philadelphia Stock Exchange formed (1st in U.S.)—U.S. government promises to redeem $80 Million of Revolutionary War scrip (= 1st stock certificates to be traded)
- **1791** The Bank Act establishes a nationwide banking structure
- **1792** May 17th: 24 merchants sign The Buttonwood Agreement and pledge to trade commodities and government scrip only with each other and for fixed commissions:
  "We the subscribers, brokers for purchase and sale of public stock do hereby solemnly promise and pledge ourselves to each other, that we will not buy or sell from this day on for any persons what-so-ever any kind of public stock at a less rate than one-quarter percent commission on the specie value of, and that we will give preference to each other in our negotiations."
  By establishing the group, public transactions are converted to private—a form of capitalism for <u>insiders</u> only (**= Trade Association**).
- **1812** War of 1812 with England leads to the establishment of 40 new banks
- **1817** Exchange is given the name "New York Stock Exchange" (NYSE)
- **1842** New York Curb Exchange is formed
- **1861-65** Scrip is issued by U.S. government to pay for Civil War
- **1862** NYSE moves to its present location—all-day trading is initiated
- **1873** America unofficially changes from silver to the gold standard (officially adopted in 1900)
- **1884** Charles <u>Dow</u> and Eddie <u>Jones</u> create an index of 9 railroad & 2 manufacturing companies
- **1913** Federal Reserve Board (FRB)established
- **1924** 1st U.S. mutual fund created by Massachusetts Investors Trust
- **1929** October 24th: Black Thursday (followed by Black Tuesday on October 29th)
  Dow closes at 230.07 (↓ 30 points or 12.8%)—equal to a $14 Billion loss of value
  Over 16 Million shares are traded on 10/29—a total not to be surpassed until 1968!
  The ticker runs behind by 147minutes
- **1930-33** Roughly 9,000 U.S. banks fail as banks underwrite and distribute securities, thus leading to conflicts of interest and unethical practices of underwriting
- **1934** Securities and Exchange Commission (SEC) established
- **1938** Maloney Act leads to formation of National Association of Securities Dealers (NASD)
  Fair Labor Standards Act establishes federal minimum wage ($0.25/hour)—it has been raised 17 times and is currently set at $5.15/hour

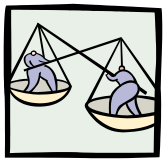
Value of Minimum Wage (*Source:* U.S. Department of Labor, http://www.infoplease.com/ipa/A0774473.html)

Year	Current Dollars	Constant (1996) Dollars
1955	0.75	4.39
1965	1.25	6.23
1975	2.10	6.12
1985	3.35	4.88
1995	4.25	4.38
2005	5.15	4.15

- **1945** FRB sets margin first margin requirement
- **1946** National debt rises to $269 Million, financed at low rates (2.5% or less)
- **1970** Securities Investors' Protection Act establishes SIPC coverage for customer protection
- **1971** February 8th: First official trading day of newly created NASDAQ system
  U.S. goes off the gold standard—no circulating paper in the world is redeemable in gold!
- **1987** October 19th: Crash Monday
  Dow closes at 1738.74 (↓ 508 points or 22.6%)—equal to a $500 Billion loss of value
  604 Million shares are traded (608 Million on Tuesday)
  The ticker runs behind by 180 minutes

III. Modern Economic Theories

A. The Laws of Supply and Demand



- Supply (S) is that which producers are willing to sell, while Demand (D) is the amount consumers are willing to buy
- If S > D, then prices must decrease to stimulate additional sales
- If D > S, then prices will rise as consumers try to out-bid each other
- S and D are always seeking equilibrium

B. Laissez-Faire ("leave it alone")

- Espouses non-intervention in monetary affairs since the economy will self-regulate if individuals are allowed to each act in their own self-interest
- True form of capitalism
- Arose in reaction to excessive taxation and government tariffs
- Competition—a basic tenet of laissez-faire—was slowly eliminated by the formation of monopolies created to control production and increase prices

C. Keynesian

- John Maynard Keynes—*General Theory of Employment, Interest and Money* (1936)
- Economy can be regulated via government intervention
- Social Security Act of 1935: introduced unemployment compensation & retirement benefits
- Employment Act of 1946: required federal government to maintain high employment levels

D. Monetary Policy

- Economy may be regulated by regulating the money supply, interest rates and the availability of credit
- M1 = cash, traveler's checks, demand deposits
  M2 = M1 + savings & money market accounts, repurchase agreements, and Eurodollars
  M3 = M2 + large time deposits (> $100K)

"FIRST I WAS A KEYNESIAN ... NEXT I WAS A MONETARIST ... THEN A SUPPLY-SIDER ... NOW I'M A BUM ..."

E. Supply-side (a.k.a. Reaganomics)

- By reducing taxes and government spending, public has more money to spend on goods and services
- Economic Recovery Tax Act of 1981: Cut taxes by 25% over 3 years
- Wealthy taxpayers benefited most from the cuts based on the assumption that they would be most inclined to reinvest their tax savings into the economy
- Tax cuts were accompanied by industry deregulation and relaxation of environmental and safety standards which led to a wave of mergers and takeovers, fueled by a strong bull market
- However, inequitable exemptions to budget cuts in military and public assistance programs led to a large budget deficit and high interest rates which made it difficult for domestic corporations to compete with foreign counterparts, ultimately leading to a devaluation of the dollar and a lack of confidence in the economy (The Crash of 1987)

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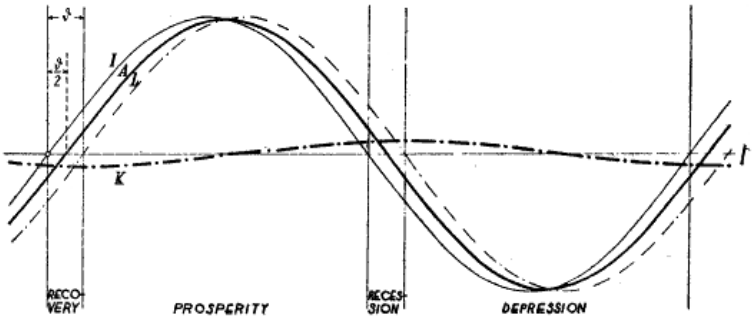
III. Practical Applications

A. Business Cycle—Four Phases



1. Prosperity
   - Marked by rise in production, employment, wages and profits

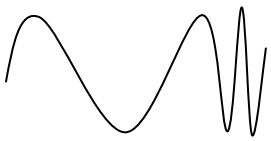
2. Recession
   - As expansion becomes over-heated, production is hampered by material shortages, costs increase, interests rates and prices rise
   - Consumers react by buying less, causing inventories to accumulate
   - Eventually manufacturers retrench and workers are laid off
   - Profits decline and money is hoarded, rather than invested

3. Depression
   - Defined as a prolonged, more severe recession

4. Recovery
   - Fueled by consumer demand of exhausted inventories and/or government intervention, manufacturers once again increase production, hire additional employees, and expand businesses

B. Behavior of Cycles

1. Duration



2. Severity

3. Regularity

4. Coincident Cycles
   i.e. prolonged slump within building industry magnified the effect of the Depression raging during the 1930's

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5. Causes

- British economist Arthur Pigou believed that naturally occurring mood swings between pessimism and optimism of the businessman influences the trend
- Sunspots (!): British economist William Jevons believed that periodically recurring sunspots affect meteorological conditions which in turn affect weather conditions and thus agricultural influences on the economy

6. Prediction via Economic Indicators (published monthly by the Conference Board)

- Leading: Production Workweek, Building Permits, Unemployment Insurance Claims, Manufacturer's Orders, Vendor Performance, Plant Contracts, Unfilled Orders, Inventory Changes, Consumer Expectations, Money Supply (M2) and Stock Prices
- Lagging: Labor Costs, Business Spending, Outstanding Bank Loans, Inventory Book Value, Unemployment Rate and Prime Rate
- Coincident: Non-farm Payroll Workers, Industrial Production, Manufacturing, Trade Sales and Personal Income

C. Stock Selection

1. Industry Types
   - Cyclical—affected by and react in tandem with the economic cycle (including housing, automobile, raw materials and defense/military spending)
   - Countercyclical—react opposite to economic cycle (including tobacco and alcohol)
   - Defensive—not adversely affected by economic cycle (including food, insurance, drugs and utilities)
   - Growth—experience marked appreciation despite economic cycle (for example, small computer industry in 1970's, dotcom's during 1990's and soft-drinks)

2. Other Theories of Market Behavior

   - Dow Theory
   - Advance/Decline, a.k.a. Breadth of Market
   - Volume of Trades
   - Moving Averages
   - January Effect
   - Contrarian Theories, including Short Interest, Sentimental Indicator and Odd Lot Trading
   - Efficient Market Theory
   - Random Walk Theory
   - Empirical theories just for fun:
     - Face hair Theory (beards are bullish)
     - Super Bowl Theory (an NFC win is bullish)
     - Wheel of Fortune (bullish if Vanna wears an off-the-shoulder gown)
     - Hemline Theory (miniskirts are bullish)
     - Years ending in "0" (bearish)
     - Presidential Elections (3rd year of term is bullish)
     - Zodiac Theory (investors sell to avoid Scorpio's sting during October)
     - Halloween Syndrome (sell to gather treats before the market plays a trick)
     - Hibernation Hypothesis (investors stockpile before hunkering down for the winter)
     - Ho, Ho, Ho Happy Holiday Factor (it's time to cash in a few chips and party down)

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