INTRODUCTION

UNDERSTANDING THE MODERN FINANCIAL WORLD: RATIONAL CHOICES IN A DIGITAL WORLD

If the Great Recession has taught us anything, it's that the modern financial world has been transformed. So it takes a bit more sleuthing to ferret out how to make money work in such a world. But using it to our best advantage doesn't have to be a mystery. We have been bombarded with a whole new financial system now largely serviced by electronic data. This has meant financial information now travels at blinding speeds, creating seemingly irrational outcomes. That is why we could have a busted housing bubble, for instance, that caused the Great Recession. Housing prices had soared 20 percent per year in some areas of the U.S. during the early 2000s, and homeowners and homebuyers came to believe prices could never fall, since average housing prices had been climbing since the Great Depression.

In the early 1980s, interest rates rose into the double digits, and homeowners with variable rate mortgages saw their mortgage payments double or triple (which happened again during the 2000 housing bubble). It caused many Savings and Loan banks to stop mortgage lending altogether. This is while savers could earn as much as 14 percent with Treasury bonds. It took more than 10 years—and 3 recessions—for inflation to come back down to the normal 2 to 3 percent. Why did the Federal Reserve push them up so high?

Today Federal Reserve Chairman Ben Bernanke and his Federal Reserve Board of Governors have pushed short term rates down to one-quarter percent so that mortgage rates have dropped lower than during World War II and even the Great Depression. Why would the Fed push rates so low, and for how long? How are ordinary consumers to make rational decisions with their money in this environment?

The best-known example of inflation in modern times was Germany. At its worst Germany reached a *monthly* inflation rate of 29,500 percent in October 1923. In December 1923, 4.2 trillion marks would get you US $1. Many historians maintain that the impoverishment of millions led to the rise of Hitler's Germany and World War II. Stories abound about the Germans' loss of wealth. Retirement pensions were destroyed, and the paper currency became even cheaper than wood or coal to burn for warmth.

Such an inflation rate is hard to believe today. Savers cannot save much these days when a one-year Treasury note pays in the neighborhood of one-seventh of 1 percent; so that $50,000 grows to just $50,070 in one year. To do any better, one has to put money in far less certain investments, like stocks. And sure enough, stock (and bond) prices have been booming since the end of the Great Recession.

So money can gain or lose value, be a sign of wealth or cause much impoverishment, if one isn't careful. That is why we worry so much about it. The Northwest Indian Kwakiutl concept of being wealthy was to give away the largest portion of their wealth in the Potlatch ceremony, which gave them the greatest status in their tribe. The Western concept of wealth is diametrically opposite. It means individually accumulating assets as private property and maximizing profits, the basis of western capitalism.

This book grew out of my weekly financial columns for a Santa Barbara, California, daily newspaper and various blogs, including the Huffington Post and Popular Economics Weekly, and is dedicated to "Promoting the Popular Understanding of Economics." Demystifying financial information for readers has always been my goal over the past thirteen years amid the breathtaking real estate and credit bubbles that have transformed both domestic and world financial markets, a world not easily understood by even the so-called financial experts.

Today, in the new digitally based Information Age of instantaneous stock trading or book buying, money works in even more mysterious ways. We know from experts, as well as our own common sense, that money is being used in many new and different ways in the modern world. One can buy, sell, save, borrow, insure, or even hedge with it. Paper and coin are becoming a thing of the past as we can either accumulate or debit money electronically.

Why was Bernie Madoff able to run a Ponzi investment scheme for so many years, or what causes interest rates to rise or decline? Why do we worry about how much money to borrow, or spend? And why are bitcoins considered a currency when they are a digital form of money traded online with no government or financial entity backing their value?

The use of the word currency for money is a clue to the mysterious way it circulates through an economy. Wikipedia defines it as: "A currency (from Middle English *curraunt,* meaning *in circulation*) in the most specific use of the word refers to money in any form when in actual use or circulation, as a medium of exchange, especially circulating paper money."

So it denotes the flow of something. Why was I given an allowance as a small kid for doing chores? I was able to save up enough to buy my first thirty-six dollar Schwinn bicycle from that allowance, which put the currency back into circulation. (I carried the money in a milk carton to the bike store and counted it all out for the owner.)

There is a common sense way of understanding the world of finance, even in our modern digital world of the Internet, search engines, and 24/7 news cycles. It requires a certain amount of sleuthing to uncover its secrets, so we can think of it as a detective story. What are the clues to look for that inform us of its availability in a way that is most useful to us?

Financial information is sometimes thought of as obscure, obtuse, an esoteric knowledge not accessible to the general public, such as you and me. The economics profession in particular is considered to be closed to outsiders who haven't learned its language. Duncan Foley's book, *Adam's Fallacy: A Guide to Economic Theory*, for instance, asserts that the economics profession has become so complex that economists are "becoming priestly figures, with arcane knowledge" and special powers. (1)

That may be so in what is called the macroeconomic world of Labor Productivity or Gross Domestic Product growth, consumer inflation, or federal budget deficits. But it isn't so in the everyday world of household finances, where inflation can be understood as food and clothing prices or rents and housing values. If we consider that economics studies the financial behavior of consumers and investors, then it is the study of human nature. And what motivates human behavior in most decision-making situations is gut instinct, intuition, and common sense—i.e., the voices of experience—which is how we know what is the best and worst for each of us.

What is common sense? The Cambridge Dictionary defines it as: "the basic level of practical knowledge and judgment that we all need to help us live in a reasonable and safe way." And certainly part of it has to be financial knowledge, since we depend on so much of the financial world—whether it is with credit cards, banks, the stock market, retirement accounts, or the value of a home.

There are a few basic assumptions we must use to understand the various indexes and indicators that measure economic activity—such as how and why interest rates fluctuate and how to access and understand government-published financial reports—but they are not difficult to understand when looked at common sensibly. For instance, interest rates fluctuate with the demand for money, which in turn influences whether we will borrow or pay cash for something.

You and I can have enough financial knowledge if we clearly understand our own wants and needs, especially our financial needs, to navigate a financial world that seems wildly out of control at the moment. The almost complete transformation of the world in just this generation has caused many to lose confidence in financial institutions. But the information revolution that spawned the transformation of stock trading, home buying, pensions, and health care systems—you name it—can help us to understand and benefit from those changes.

Leveling the financial playing field for consumers and investors is what this book is about. How we decide to spend and invest wisely is a function of self-knowledge and the awareness of one's own decision-making abilities. Using publicly available, common sense information, I will show how the information revolution can help the ordinary consumer become better informed, and less reliant on hunches and hearsay that have caused so much of the irrational exuberance manifested by investors in the financial and housing markets. This is how we can make rational choices (to use an economic term) even though we may live in a world that seems so out of our control that it is no longer easily described, or even seems rational and understandable to the ordinary employee, investor, and homeowner.

It is a revolution that Yale University economist Robert J. Shiller describes in his book, *The New Financial Order: Risk in the 21st Century*, which we will discuss in future chapters:

> "Right now we are witnessing an explosion of new information systems, payment systems, electronic markets, online personal financial planners, and other technologically induced economic innovations, and consequently much in our economy will be changed within just a few years. Almost all of our economy will be transformed within just a few decades." (2)

Establishing and disseminating the historical record should help policy makers avoid endlessly repeating history's mistakes. The historical study of the Great Depression is one reason Presidents George W. Bush and Barack Obama were able to inject enough stimulus into our economy to avoid another Great Depression. And it helps bring about our own greater awareness of the financial environment that affects us as consumers and investors.

Much has changed since the time of small market towns glorified by Adam Smith in his book, *The Wealth of Nations*, published in 1776, a time in which everyone knew their neighbors and were suspicious of strangers who lacked a good reputation. The small-town markets that were guided by the invisible hand of enlightened self-interest with very little government regulation or taxes disappeared in the last century as populations and cities grew. But human nature hasn't changed. Former Chairman of the Federal Reserve Alan Greenspan, who served under two presidents, has said:

> "It is not that humans have become any more greedy than in generations past. It is that the avenues to express greed had grown so enormously." (3)

What are those avenues? Financial markets in particular are so opaque to the uninformed eye that they can be controlled and manipulated in part due to information biases, such as inside traders' superior knowledge of their markets. Several Nobel prizes have been won from these insights. We will also discuss so-called information biases, a situation in which insiders can wreck markets if regulations such as insider trading rules, or lemon laws and warranties for used cars, aren't enforced.

In fact, the future is not predictable, nor are present events very well understood. So we rely on hunches, opinions of others, and predispositions that make up what economist John Maynard Keynes called "animal spirits," which are emotions that Nobel Prize winners George A. Akerlof and Robert Shiller break down into five elements: *confidence, fairness, corruption and antisocial behavior, money illusion, and stories* that we will learn more about in the chapter on Irrational Exuberance*.* We will also learn more about those elements that make it easier for insiders to manipulate and mislead investors. (4)

Behavioral economists in particular, as well as psychologists and sociologists, have focused on the irrational behavior of individuals, such as those who would invest in housing or the stock market at the height of their respective bubbles. But I will show that consumers and investors can and do make intelligent decisions. When market information is neither readily available nor even intelligible except to those players who profit from a lack of transparency, it is much more difficult to make intelligent financial choices. In fact the lack of transparency, hiding under the rationale of deregulation and free market ideology has created much of the inequality of wealth that is a feature of today's U.S. economy. Most of us can control our choices, but not our environment. So it is necessary to pull back the curtain that obfuscates and confuses the ability to make intelligent decisions.

A mundane example is investing in real estate—the only major investment most make in a lifetime. How were homebuyers to know that too many homes were being built for the number of eligible homebuyers during the last decade? Former Fed Chairman Alan Greenspan said once that housing wasn't susceptible to a bubble. Why? Because it couldn't be traded like stocks or commodities—and besides, there is only so much available land. But Greenspan didn't count on the various "liar" loans that sprang up during the housing bubble, making real estate as easy to buy and sell as stocks and bonds.

Then how do we make rational choices in such a complex world? The main vehicle for change is already visible and a result of the exploding Information Age—greater access to our historical record, and the ability to broadcast it to a wider public. Wikileaks is only the latest manifestation of the ability to disseminate formerly secret or privately held information by the few to a wider public via the Internet. In fact, I will show that enough of the information you and I need to make rational financial decisions is now publicly available.

This book starts out with a short, common sense summary of why the fastmoving innovations of the Information Age have led to the temporary decline of economic opportunity for so many—both on the micro (individual) and macro (national-worldwide) level. It is followed by a survey of the sources available to help us navigate the information web to discriminate between what is real and bogus information. For instance, what are the safeguards against snake oil salesmen pitching the latest financial fads in the quest for financial security? And how will the micro changes in individual lives translate to larger macro changes that build in less financial risk? The subtitle of Schiller's book, *The New Financial Order*, is *Risk in the 21st Century*, after all. Where are financial risks greater or less, and how does one avoid—or at least be aware of—the riskier choices?

Above all, the issue of rational choice will be looked at. This has provoked endless debate among academic economists, in particular. Was it rational to buy at the top of the real estate or stock markets, just because the markets were rising and others were doing so?

I will also survey writings about herd behavior in financial markets that help to understand the motivations for what investors do, and what constitutes common sense behavior. In spite of so much advanced technology and education, humankind still relies on a brain and thinking patterns that evolved over millions of years to cope with a much more hostile physical environment. In fact, until the Industrial Revolution humankind had no knowledge of fractions, percentage calculations, and the more complex mathematics that control so much of modern financial markets.

Much has been written about the transfer of wealth from the middle and lower classes to the top 1 percent income bracket, leading to the greatest inequality Americans have experienced since the Great Depression. And we as financial animals have to face the fact that neither politicians nor economists have reached agreement on what will restore real economic prosperity to the other 99 percent.

That is the background that has put so many at a disadvantage in bettering their own financial condition. President Bill Clinton's labor secretary, Robert Reich, describes the historical pendulum swings best in his latest book, *Aftershock*:

> "We have been at this juncture before. Our history swings much like a pendulum between periods during which the benefits of economic change are concentrated in fewer hands, and periods during which the middle class shares broadly in the nation's prosperity and grows to include many of the poor—between periods during which we see ourselves as "in it together," and periods during which we view ourselves as being pretty much on our own." (5)

That means it is really up to us as individuals to find ways to better our own standard of living. It is in our power to rebalance our pocketbooks and avoid another Great Recession or Great Depression—if we sharpen our financial wits. Only then can you and I share in the abundance from the ever-growing American economy.

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